Supreme Court, U.S.
FILED

941204 JAN 10 1995

OFFICE OF THE CLERK

No.

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1994

ALEXANDER SHOKAI, INC.,
EDWARD ALEXANDER, ESTELLE ALEXANDER,
Petitioners,
VS.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition For Writ of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit

PETITION FOR WRIT OF CERTIORARI AND APPENDIX

*RONALD K. VAN WERT, ESQ.
A Member of Ronald K. Van Wert
A Professional Corporation
1301 Dove Street, Suite 900
Newport Beach, California
92660-2448
(714) 752-7964

**Counsel of Record for Petitioners*
Alexander Shokai, Inc.,
Edward Alexander
and Estelle Alexander

Bowne of Los Angeles, Inc., Law Printers (213) 627-2200

QUESTIONS PRESENTED FOR REVIEW

WHETHER A NEW TRIAL IS REQUIRED WHEN THE TAX COURT, DURING A CRITICAL STAGE OF A CIVIL TAX FRAUD CASE, CONDUCTS AN UNJUSTIFIED *EX PARTE* HEARING WITH GOVERNMENT COUNSEL IN WHICH THE MERITS OF THE CASE AND THE CREDIBILITY OF THE TAXPAYERS' WITNESSES ARE DISCUSSED.

WHETHER REVERSAL IS REQUIRED WHEN THE TAX COURT REFUSED TO RULE UPON THE ADMISSIBILITY OF PROFFERED EVIDENCE.

WHETHER THE PRINCIPLE ESTABLISHED BY THIS COURT IN COMMISSIONER V. INDIANAPOLIS POWER & LIGHT CO., 493 U.S. 203 (1990) IS LIMITED TO LOAN OR DEPOSIT CASES.

WHETHER THE IMPOSITION OF TAX PENALTIES OF OVER SIX HUNDRED THOUSAND DOLLARS ($600,000) VIOLATES PETITIONERS' RIGHT TO DUE PROCESS AND IS EXCESSIVE UNDER THE PROVISIONS OF THE EIGHTH AMENDMENT.

LIST OF PARTIES TO THE PROCEEDINGS IN THE COURT BELOW

The caption of the case in this Court contains the names of all parties to the proceedings in the United States Court of Appeals for the Ninth Circuit.

Petitioner ALEXANDER SHOKAI, INC. has changed its name to ALEXANDER SPORTS CORPORATION. It has no, and has had, no parent company or subsidiary.

TABLE OF CONTENTS

PAGE NO.

QUESTIONS PRESENTED FOR REVIEW i

LIST OF PARTIES TO THE PROCEEDINGS IN THE COURT BELOW ii

TABLE OF CONTENTS iii

TABLE OF AUTHORITIES vii

PETITION FOR WRIT OF CERTIORARI 1

OPINIONS BELOW 2

STATEMENT OF JURISDICTION 3

CONSTITUTIONAL PROVISIONS, TREATIES, STATUTES, RULES AND REGULATIONS INVOLVED 4

STATEMENT OF THE CASE 7

1. BACKGROUND 7

2. TAX COURT PROCEEDINGS 11

   A. THE PETITIONS AND MOTION TO QUASH 11

   B. THE *EX PARTE* HEARING . . 12

   C. THE TAX COURT TRIAL . . 14

3. THE OPINION AND EVIDENTIARY RULING 16

4. COURT OF APPEALS 18

REASONS FOR GRANTING THE WRIT 19

1. SUMMARY 19

2. ARGUMENT 22

A. THE COURT OF APPEALS' REFUSAL TO REVERSE AFTER FINDING UNJUSTIFIED *EX PARTE* COMMUNICATIONS BY THE COURT AND COMMISSIONER'S COUNSEL IS IN CONFLICT WITH APPLICABLE DECISIONS OF THIS COURT AND THE DECISION OF ANOTHER FEDERAL COURT OF APPEALS 22

B. WHEN THE CENTRAL ISSUE IS ONE OF DISCLOSURE OF INCOME TO THE PETITIONERS' CERTIFIED PUBLIC ACCOUNTANT, THE TAX COURT WAS OBLIGATED TO CONSIDER EVIDENCE RELEVANT TO THAT ISSUE . 25

(1) The Issue 26

(2) The Significance Of The Excluded Evidence 27

C. THE APPLICATION BY THE COURT OF APPEALS OF THE PRINCIPLE OF *INDIANAPOLIS POWER & LIGHT CO.* TO ONLY LOAN AND DEPOSIT CASES IS IN CONFLICT WITH THE DECISION ITSELF AND IN CONFLICT WITH THE DECISION OF ANOTHER COURT OF APPEALS 33

D. WHETHER THE FAILURE TO HAVE A REVIEW PROCEDURE FOR FRAUD PENALTIES VIOLATES DUE PROCESS AND WHETHER THE AMOUNT IS EXCESSIVE UNDER THE EIGHTH AMENDMENT SHOULD BE SETTLED BY THIS COURT 35

(1) May A Successor Transferee Be Liable For A Fraud Penalty Due To the Act Or Omission Of His Predecessor? . . . 36

(2) Is The Application Of the Penalty Excessive As To The Individual Petitioners? . . . 37

CONCLUSION 38

APPENDIX 39

Opinion of the Court of Appeals for the Ninth Circuit 40

Order of the Court of Appeals for the Ninth Circuit 82

Memorandum Findings of Fact and Opinion of the United States Tax Court 83

Order of the United States Tax Court 192

Decision of the United States Tax Court in case number 16443-89 . 199

Decision of the United States Tax Court in case number 16543-89 . 203

Decision of the United States Tax Court in case number 18181-89 . 207

TABLE OF AUTHORITIES

CASES — PAGE NO.

Betson v. Commissioner,
802 F. 2d 365 (9th Cir. 1986) 30

Commissioner v. Indianapolis
Power & Light Co.,
493 U.S. 203 (1990) . . 17, 20, 21, 33-35

Concord Instruments Corp. v. Commissioner,
64 T.C.M. 979 (1992) 34, 35

Guenther v. Commissioner,
889 F. 2d 882 (9th Cir. 1989) 25

Guenther v. Commissioner,
939 F. 2d 758 (9th Cir. 1991) 23

Rose v. Clark,
478 U.S. 570 (1986) 22-24, 31

United States v. Boyle,
469 U.S. 242 (1985) 30

United States v. Claiborne,
765 F. 2d 784 (9th Cir. 1985)
cert. denied 475 U.S. 1120 (1960) . . . 31

United States v. Cronic,
466 U.S. 648 (1984) 22

United States v. Minsky,
963 F. 2d 870 (6th Cir. 1992) 23

Ware v. Commissioner,
906 F. 2d 62 (2d Cir. 1990) 20

CONSTITUTIONAL PROVISIONS

U.S. Constitution Amendment V . 4, 21, 35

U.S. Constitution Amendment VIII . 5, 21, 38

STATUTES

26 U.S.C. § 6901(a) 36

26 U.S.C. § 6901(a)(1) (1986) 21

26 U.S.C. § 6901(a)(2) 21, 36

26 U.S.C. § 7441 12

26 U.S.C. § 7442 12

26 U.S.C. § 7483 18

28 U.S.C. § 1254(1) 3

RULES AND REGULATIONS

Federal Rules of Evidence, Rule 401 . . 5

Federal Rules of Evidence, Rule 402 5, 31

No. _____

In The
SUPREME COURT OF THE UNITED STATES
October Term, 1994

ALEXANDER SHOKAI, INC.,
EDWARD ALEXANDER, ESTELLE ALEXANDER,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

Petitioners, ALEXANDER SHOKAI, INC., EDWARD ALEXANDER and ESTELLE ALEXANDER, respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit entered in the above-entitled case on September 2, 1994.

OPINIONS BELOW

The September 2, 1994, Opinion of the Court of Appeals whose judgment is herein sought to be reviewed, is published. The Court of Appeals issued its Opinion on September 2, 1994, and issued its Order denying Petitioners' Combined Petition for Rehearing and Suggestion for Rehearing In Banc on October 13, 1994. United States Court of Appeals for the Ninth Circuit case number is 93-70101. The Opinion and Order are reprinted in the Appendix to this Petition, pp. 40 and 82.

The Decisions of the United States Tax Court were entered on July 13, 1992, pursuant to its Opinion issued on January 21, 1992, in case numbers 16443-89, 16543-89 and 18181-89. The Opinion was published and is reprinted in the Appendix to this Petition, p. 83.

STATEMENT OF JURISDICTION

The Judgment of the Court of Appeals was entered on September 2, 1994.

Petitioners filed a Combined Petition for Rehearing and Suggestion for Rehearing In Banc on September 15, 1994. On October 13, 1994, the Court of Appeals issued its Order denying the Petition for Rehearing and rejecting the suggestion for rehearing in banc. On December 12, 1994, the Court of Appeals issued its mandate.

The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

CONSTITUTIONAL PROVISIONS, TREATIES, STATUTES, RULES AND REGULATIONS INVOLVED

Amendment V to the United States Constitution:

> "No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offense to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor

shall private property be taken for public use, without just compensation."

Amendment VIII to the United States Constitution:

"Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted."

Rule 401, Federal Rules of Evidence:

"'Relevant evidence' means evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence."

Rule 402, Federal Rules of Evidence:

"All relevant evidence is admissible, except as otherwise provided by the Constitution of the United States, by Act of

Congress, by these rules, or by other rules prescribed by the Supreme Court pursuant to statutory authority. Evidence which is not relevant is not admissible."

STATEMENT OF THE CASE

1. BACKGROUND

In about 1960, Petitioner EDWARD ALEXANDER ("ALEXANDER") became a wholesaler for Gosen, Ltd., a Japanese corporation ("Gosen") to sell synthetic string for tennis rackets. By the late 1970's, ALEXANDER had formed a corporation, E. Alexander, Inc., who purchased the string from Gosen and resold it in the United States to tennis racket companies. In about 1979, ALEXANDER learned that Gosen paid commissions on sales and reached agreement with Gosen to pay him a commission on sales generated through his efforts including sales to E. Alexander, Inc. As part of the agreement, ALEXANDER was required to repay Gosen if the Japanese National Taxing Administration determined that the commission payments were not deductible. The agreement also provided that the payment by Gosen was to be made in Japan at a bank

designated by ALEXANDER. The bank designated by ALEXANDER was the Bank of America, Osaka, Japan.

At the time of his negotiations with Gosen, ALEXANDER contacted his long time adviser and accountant, Kenneth Bartelt, who advised ALEXANDER that the commission payments were not reportable in the United States, at least until they were brought into the United States.

Each year between 1980 and 1984, ALEXANDER brought into the United States some of the Gosen funds and he deposited them into his Bank of America account(s) in the United States. ALEXANDER provided to his accountant, Edward Bartelt, C.P.A. the son of Kenneth Bartelt, the amount of funds brought into the United States which amounts were set forth on financial statements prepared by Edward Bartelt. Edward Bartelt asserted at trial that he was unaware of the source of funds and that he made no inquiry

as to the source even though the financial statements prepared by him showed increases in cash, or cash equivalent, of hundreds of thousands of dollars. Edward Bartelt was also the Chief Financial officer of E. Alexander, Inc., (and its successor Petitioner ALEXANDER SHOKAI, INC.) and prepared tax returns for the individual Petitioners and E. Alexander, Inc.

Between 1980 and 1984, Gosen was audited by the Japanese National Taxing Administration ("JNTA") and in 1984 the taxing authorities approved the propriety of the payment of the commissions to ALEXANDER. Because of the issue of kickbacks, which had become a significant issue in Japan as a result of the Lockheed scandal involving kickbacks to Japanese officials, the JNTA requested assistance from the Internal Revenue Service in determining if any of the commissions paid to ALEXANDER were returned to Gosen. The investigation was turned over

to the Criminal Investigation Division of the Internal Revenue Service who found, after interviewing ALEXANDER in 1984, that there was no kickback but continued the investigation on the issue of whether the income was reportable when received.

During the investigation, ALEXANDER retained tax counsel and other tax advisers to assist him and Petitioner ALEXANDER SHOKAI, INC. in determining the taxability of the commissions and the timing of recognition. As a result of the completion of the audit by the JNTA in 1984, ALEXANDER and Petitioner ALEXANDER SHOKAI, INC., were advised to report the payments in calendar year 1984 and taxes were paid timely with respect to such reporting.

After the conclusion of the criminal investigation and submission of the case to the United States Attorney, the criminal prosecution of the case was declined. The Internal Revenue Service proceeded with

issuing notices of deficiency asserting that the income was reportable in the year of receipt and was taxable both at the corporate level as well as the individual level. It asserted the fraud penalty against ALEXANDER and the successor corporation of E. Alexander, Inc., ALEXANDER SHOKAI, INC., but did not assert the fraud penalty against ALEXANDER's spouse, Petitioner ESTELLE ALEXANDER. Other underpayment penalties were also asserted.

As a result of the duplication of penalties and taxes, at both the individual and corporate level, the taxes and penalties exceeded the total amount of the Gosen receipts.

2. TAX COURT PROCEEDINGS

A. THE PETITIONS AND MOTION TO QUASH

In 1989 Petitioners sought a redetermination of the taxes and penalties by filing petitions in the United States Tax Court. The Tax Court had jurisdiction to

hear and determine the petitions under sections 7441 and 7442 of 26 U.S.C. Prior to trial, counsel for COMMISSIONER in statements and briefs to the court, painted ALEXANDER and Petitioners' potential witnesses as well as their counsel, as fabricators and conspirators. The counsel for the COMMISSIONER also sought to subpoena non-party tax records in the possession of Petitioners' accountant, Mr. Edward Bartelt, which resulted in Mr. Bartelt, through his independent counsel, filing a motion to quash.

Because the motion to quash did not concern the Petitioners, Petitioners' counsel received permission from the Tax Court to be excused from the hearing on the motion to quash.

B. THE *EX PARTE* HEARING

After the court ruled upon the motion to quash, it did not terminate the hearing even though it was reminded of the absence

of the Petitioners' counsel. The court and counsel for the COMMISSIONER began an extensive discussion of the COMMISSIONER'S theory of the case, the purported theory of Petitioners' case, the credibility of witnesses who had been listed by Petitioners, a purported investigation by the Internal Revenue Service in Japan (there was none), and the purported misconduct of Petitioners' counsel.

At one point during the *ex parte* hearing, the Tax Court stated that it would, "take action" against one of Petitioners' expert witnesses for purported noncompliance with another subpoena served by the COMMISSIONER and:

> "give serious consideration to a motion from the [COMMISSIONER] to prohibit [the expert witness] from being a witness."

[Reporter's Transcript of December 10, 1990, p. 41, lls. 16--20.] The Tax Court in its

Opinion and evidentiary ruling disregarded the testimony of the expert witness.

At another point during the *ex parte* hearing, the COMMISSIONER's counsel stated that he had been "stonewalled" with respect to a deposition by written questions taken in Japan. This deposition, which by prior agreement was to be admitted into evidence, was subsequently excluded by the Tax Court on the basis that it was "unnecessary" for its decision.

After the *ex parte* hearing, Petitioners' counsel learned for the first time of the existence of the *ex parte* hearing from counsel for Mr. Bartelt.

C. THE TAX COURT TRIAL

At the beginning of trial, Petitioners' counsel moved for sanctions for misconduct of the COMMISSIONER and his counsel as a result of the *ex parte* hearing. The Tax Court summarily denied the motion and offered no explanation of the reason for the

ex parte hearing and provided no details as to the extensive discussion that had taken place or an opportunity for Petitioners to respond to any misstatement of fact. After making a negative comment that some of the motions of Petitioners served no purpose, the Court began almost immediately to "warn" Petitioners' counsel about the use of experts and at one point referred to trial by "ambush" when Petitioners' counsel questioned, on direct, the Petitioners' accounting expert about his report. It then excluded this accounting expert of Petitioners from assisting Petitioners during the testimony of Mr. Edward Bartelt, who was a key to Petitioners' reliance defense.

With respect to their reliance defense, the Petitioners sought to introduce the working papers and financial reports of their accountant, Edward Bartelt, to show that the funds brought into the United

States were reported to Mr. Bartelt and the awareness of the accountant himself of the substantial funds being deposited by ALEXANDER from a source other than salary and asset appreciation. This proffered evidence included, among other things, the contemporary (1980--1984) personal financial statements of the ALEXANDERS and E. ALEXANDER, INC.'s statements of income and changes in financial position. The Tax Court refused to rule until after trial as to the relevancy of this evidence and the admissibility of the written deposition of Gosen's President, a deposition which dealt with key issues in ALEXANDER's defense.

3. THE OPINION AND EVIDENTIARY RULING

In its post-trial ruling, more than one year after the trial, the Tax Court ruled that the proffered evidence concerning the contemporary financial records of ALEXANDER and E. Alexander, Inc., as well as the written deposition of the President of

Gosen, were "unnecessary" for its decision and refused to rule upon their relevancy. It also found it unnecessary to rule upon the expert qualifications of one of Petitioners' experts because it was also "unnecessary" for its decision.

Though it found that ALEXANDER had an obligation to return the payments to Gosen if the JNTA disallowed the deduction, it ruled that the principle established by this Court in Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990) only applied to loan and deposit cases.

It found that ALEXANDER had been advised by Kenneth Bartelt that the Gosen proceeds were not reportable when received in Japan but that ALEXANDER had not reported it to his accountant in the United States. In its Opinion the Tax Court made no reference to the extensive contemporary financial records which showed disclosure of the amounts brought into the United States

by ALEXANDER and it made virtually no mention of the trial testimony of Edward Bartelt who acknowledged that he had failed in his duty as a certified public accountant to determine the source of the payments reported to him by ALEXANDER.

Except for 1984, when the tax returns of Petitioners had disclosed the existence of the Internal Revenue Service audit, the Tax Court found in favor of the COMMISSIONER on all issues and sustained the fraud and other penalties as against both the successor of E. ALEXANDER, INC. and Petitioner ALEXANDER.

4. COURT OF APPEALS

The Court of Appeals had jurisdiction to hear and determine the appeal of Petitioners under 26 U.S.C. § 7483. Though finding that the *ex parte* communications between the Tax Court and the Respondent were improper, the Court of Appeals affirmed the entire decision of the Tax Court.

REASONS FOR GRANTING THE WRIT

1. SUMMARY

The Judgment of the United States Court of Appeals for the Ninth Circuit should be reviewed by this Court because in affirming the decision, the Court of Appeals both departed from the accepted and usual course of judicial proceedings and sanctioned such a departure by the lower court. The Judgment should be reviewed because it is also in direct conflict with decisions of this Court, as well as with other Courts of Appeals.

The Court of Appeals departed from the accepted and usual course of judicial proceedings in that it found error with respect to the *ex parte* hearing but refused to reverse or order a new trial. It made no finding that the COMMISSIONER had proven a lack of prejudice or that the error was harmless beyond a reasonable doubt. It also refused to reverse or order a new trial even

though the Tax Court failed to either consider highly relevant evidence or to set forth its legal reasons for its exclusion from consideration.

Petitioners assert that these departures require the exercise of this Court's power of supervision because both the Court of Appeals and the lower court have deprived the Petitioners of their right to a fair trial and their right to due process.

As an additional basis for review, the Judgment of the Court of Appeals for the Ninth Circuit limits the application of Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990) to loan and deposit cases. This decision is an unwarranted limitation of Indianapolis Power & Light and is in conflict with the decision of the Second Circuit in Ware v. Commissioner, 906 F. 2d 62 (2d Cir. 1990), where the court adopted the position of the COMMISSIONER

that Indianapolis Power & Light applied to a case which was not a loan and deposit case.

The fraud penalty imposed against ALEXANDER and ALEXANDER SHOKAI, INC., the successor to E. Alexander, Inc., may also be a violation of the Eighth Amendment and the Fifth Amendment in that the penalty has no relationship to the harm to the COMMISSIONER. Its duplication at both the individual and corporate level affects the innocent spouse, Petitioner ESTELLE ALEXANDER, because of her community property interest in the successor corporation. The application of the fraud penalty to a third party successor as a result of the Tax Court's and Court of Appeals' construction of 26 U.S.C. § § 6901(a)(1) and 6901(a)(2) to a successor corporation regardless of fault is constitutionally infirm.

There is no statutory provision which allows either the Tax Court or the Court of

Appeals to determine whether the penalties asserted against a taxpayer are excessive. The application of the fraud penalty is automatic once fraud is found without the right of any judicial review or reduction even if found excessive.

2. ARGUMENT

A. THE COURT OF APPEALS' REFUSAL TO REVERSE AFTER FINDING UNJUSTIFIED *EX PARTE* COMMUNICATIONS BY THE COURT AND COMMISSIONER'S COUNSEL IS IN CONFLICT WITH APPLICABLE DECISIONS OF THIS COURT AND THE DECISION OF ANOTHER FEDERAL COURT OF APPEALS

Since Petitioners' counsel was absent during a critical phase of the Tax Court hearing (he was mislead as to the purpose of the hearing), the Court of Appeals should have reversed regardless of any showing of prejudice. United States v. Cronic, 466 U.S. 648, 659 n. 25 (1984); Rose v. Clark, 478 U.S. 570, 577 (1986). Reversal has been mandated even where the Judge is not the

trier of fact. See, United States v. Minsky, 963 F. 2d 870 (6th Cir. 1992). When the trier of fact is the very person who conducted the prohibited hearing, his decision is so tainted by the impropriety that reversal is necessary because the error renders the trial fundamentally unfair. See, Rose v. Clark, 478 U.S. 570, 577 (1986).

The rules in criminal cases concerning *ex parte* communications have been applied to civil tax fraud cases because of the extreme penalties facing the taxpayer. Guenther v. Commissioner, 939 F. 2d 758, 760--761 (9th Cir. 1991).

If reversal is not automatic, then the COMMISSIONER must prove lack of prejudice which is a heavy burden. United States v. Minsky, supra. Since the COMMISSIONER never conceded error, it offered no evidence to disprove prejudice. Instead, the COMMISSIONER asserted to the Court of

Appeals in its brief at page 48 that the:

> "*ex parte* communications 'were made within the scope of the purposes of the pre-trial hearing.'"

This was a quote by the COMMISSIONER of the Tax Court's rationale for the *ex parte* communication, a rationale completely rejected by the Court of Appeals.

This case involved specific *ex parte* discussions with the trier of fact of the merits of the case, the conduct of Petitioners' counsel, and the credibility of witnesses. It involved misstatements of fact. What more prejudice could the Petitioners prove even if they had the burden of proof?

The Court of Appeals did not declare that the constitutional error by the Tax Court and the COMMISSIONER was harmless beyond a reasonable doubt. Rose, supra at 583. Therefore, the case should be remanded

even if reversal is not automatic.

By not reversing the judgment of the Tax Court, the Court of Appeals has sent the wrong message to both the COMMISSIONER and the Tax Court. This *ex parte* communication took place more than a year after the same Circuit had warned the Tax Court about *ex parte* communications. Guenther v. Commissioner, 889 F. 2d 882 (9th Cir. 1989). Contrary to its statement in Guenther, supra that it would not tolerate *ex parte* communication, it did and has. This Court is asked to exercise its supervisory authority to end a disregard of due process by the Tax Court.

B. WHEN THE CENTRAL ISSUE IS ONE OF DISCLOSURE OF INCOME TO THE PETITIONERS' CERTIFIED PUBLIC ACCOUNTANT, THE TAX COURT

WAS OBLIGATED TO CONSIDER EVIDENCE RELEVANT TO THAT ISSUE

(1) The Issue

The linchpin of the Tax Court's decision and that of the Court of Appeals is that ALEXANDER did not disclose to his accountant, Edward Bartelt, the Gosen payments that he brought into the United States, which they reasoned precluded the application of the reliance defense. The proffered evidence was to the contrary. The Tax Court refused to consider or rule upon the significance of contemporary financial records prepared by Mr. Bartelt during the periods in question that disclosed what ALEXANDER had provided to Mr. Bartelt and the awareness of the accountant himself of substantial funds being deposited from a source other than salary and asset appreciation.

The Tax Court even refused to consider Edward Bartelt's penciled changes

to the Personal Financial Statements where the cash, or cash equivalent, had increased in one year by over $800,000 (Exhibit 65). The evidence contained in the excluded exhibits was a key part of Petitioners' case that ALEXANDER did fulfill what he believed to be his responsibility to report to his accountant any income, regardless of source, that he deposited in the United States.

(2) The Significance Of The Excluded Evidence

Prior to the time period involved in this dispute, Kenneth Bartelt was engaged by ALEXANDER to provide all the accounting and income tax services for ALEXANDER and his businesses. Subsequently, including the relevant time period, ALEXANDER engaged the services of Kenneth Bartelt's son, Edward Bartelt, to provide all of the accounting and income tax services to ALEXANDER and his businesses. Edward Bartelt was appointed Chief Financial Officer of E. Alexander,

Inc. During the time that funds were being transferred from the Osaka account to the United States account, Edward Bartelt prepared Personal Financial Statements of ALEXANDER on an annual or more frequent basis, for which Mr. Bartelt, as a certified public accountant, was required to include the current and/or deferred income tax liabilities relating to the assets disclosed by ALEXANDER and stated on the financial statements. An examination of the drafts of the statements showed that Edward Bartelt followed the procedure of utilizing the prior financial statements by crossing out the old amounts and writing in the new amounts. Since the cash and cash equivalent amounts furnished by ALEXANDER to Edward Bartelt rose substantially during the periods in question, it was necessary for Edward Bartelt to determine the income tax significance relating to these substantial increases. By following accepted accounting

standards and procedures Edward Bartelt, a certified public accountant, was required to be aware of the specific nature and identity of the source of the asset increments in order to complete the preparation of the Personal Financial Statements.

Edward Bartelt also prepared ALEXANDER's personal income tax returns knowing of the substantial increases in ALEXANDER's United States cash accounts and other cash equivalent assets. It would not be possible for Edward Bartelt to properly prepare the tax returns without determining the proper income tax liabilities involved. To do so required Edward Bartelt to know the source and nature of the Osaka cash funds.

In this case, Edward Bartelt also prepared Personal Financial Statements for ALEXANDER. To prepare these statements he was supplied the amounts of all of ALEXANDER's assets. In addition, he had

access, as an officer, to all of the company's records.

Accordingly, completion of the preparation of the financial statements by Edward Bartelt, pursuant to generally accepted accounting principles and standards, required that he be completely familiar with the source and nature of the Osaka account funds.

The failure to determine the source of the income, the taxability of the Gosen income and include it in the tax returns was the failure of Edward Bartelt and not the Petitioners. This Court has long recognized that the failure of the accountant is not chargeable to the taxpayer with respect to penalties. United States v. Boyle, 469 U.S. 242 (1985); see also, Betson v. Commissioner, 802 F. 2d 365 (9th Cir. 1986).

The Tax Court's refusal to consider or rule upon the admissibility of

highly relevant financial records is a violation of the Petitioners' right to due process in that they were not provided the full opportunity to put on evidence. Rose, 478 U.S. at 579. Though the relevancy of the proffered evidence was not even a close call, the Tax Court made no call as to why it was not "necessary" or not admissible. As stated in Rule 402, Federal Rules of Evidence:

> "all relevant evidence is admissible, except as otherwise provided . . . . .."

There was no factual or legal basis for its exclusion. It was "necessary" for the Tax Court's decision and is another indication of the prejudice created from the *ex parte* hearing in this case.

The Court of Appeals in sustaining the Tax Court relied upon the case of United States v. Claiborne, 765 F. 2d 784, 798 (9th Cir. 1985) cert. denied 475 U.S. 1120 (1960)

for the proposition that ALEXANDER could not rely on Edward Bartelt because he had not made, "a full disclosure of tax related information." The rejected evidence clearly illustrated that ALEXANDER had made a full disclosure of tax related information. The Petitioners were entitled to have the evidence considered and ruled upon. Due process is not satisfied when the trier of fact only rules that the evidence was, "unnecessary for its decision." If it was rejected, the court was obligated to set forth its reasons for rejecting evidence that showed ALEXANDER's full disclosure of tax related information. There is no duty upon a taxpayer to describe the source of the income itself so long as the income or payment is disclosed to the accountant. It is the fault of the accountant and not the taxpayer if the accountant does not make the elementary determination as to whether the disclosed amount is taxable. This does not

absolve the taxpayer of the tax and interest. It does absolve the taxpayer of fraud penalties.

C. THE APPLICATION BY THE COURT OF APPEALS OF THE PRINCIPLE OF *INDIANAPOLIS POWER & LIGHT CO.* TO ONLY LOAN AND DEPOSIT CASES IS IN CONFLICT WITH THE DECISION ITSELF AND IN CONFLICT WITH THE DECISION OF ANOTHER COURT OF APPEALS

This Court did not limit the principle it established in Indianapolis Power & Light Co., supra, to loan and deposit cases. The Court stated at 493 U.S. 210:

> "the crucial point is not whether [the taxpayer's] use of the funds is unconstrained during some interim period. The key is whether the taxpayer has some guarantee that he will be allowed to keep the money."

The Commissioner successfully asserted in the Second Circuit that the rationale of

Indianapolis Power & Light Co. was not limited to loan and deposit cases. As was found by the Tax Court, ALEXANDER had no guarantee that he would be allowed to keep the money unless the JNTA approved the deduction of the payments by Gosen. Thus, prior to completion of the audit there were restrictions on the money which were removed in 1984. Once the restrictions were removed, the Gosen receipts were reported as income.

The proffered evidence, and rejected evidence, also showed that ALEXANDER maintained a substantial cash and/or cash equivalent balance at all times until completion of the audit. See, Concord Instruments Corp. v. Commissioner, 64 T.C.M. 979 (1992) where the Tax Court held that the taxpayer was not liable to report customer receipts pending an audit by the Internal Revenue Service even though the taxpayer had full access to the receipts. Both in

Concord and in this case, the taxpayers had sufficient liquid funds to return the disputed funds. ALEXANDER had maintained this reserve because of the uncertainty of his ability to keep the money. As in Indianapolis Power & Light Co. there was no guarantee and the control of whether it could be retained was in the hands of the JNTA. The Tax Court erred in both limiting the application of Indianapolis Power & Light Co. and in refusing to admit into evidence documents showing Petitioners' liquid position.

D. WHETHER THE FAILURE TO HAVE A REVIEW PROCEDURE FOR FRAUD PENALTIES VIOLATES DUE PROCESS AND WHETHER THE AMOUNT IS EXCESSIVE UNDER THE EIGHTH AMENDMENT SHOULD BE SETTLED BY THIS COURT

(1) May A Successor Transferee Be Liable For A Fraud Penalty Due To the Act Or Omission Of His Predecessor?

Petitioners asserted at trial that a transferee is not liable for a fraud penalty because of section 6901(a) and (a)(2) of the Internal Revenue Code ("Code").

The Court of Appeals and Tax Court ruled otherwise. This construction of the relevant statutes by the Court of Appeals and the Tax Court creates the imposition of a penalty, or fine, of over $250,000 against ALEXANDER SHOKAI, INC.[1] even though it was not in existence at the time when the fraud was found by the Tax Court to have occurred.

---

[1]Though the successor corporation is owned by Petitioner ALEXANDER, and as a result of community property laws his spouse, ESTELLE ALEXANDER, this was not the basis for the imposition of the penalty. Based upon the Tax Court's and Court of Appeals' rationale, a successor corporation is always liable for the fraud penalty attributable to its predecessor corporation regardless of the business reason for the merger.

This is in addition to the taxes on the income and the tax and fraud penalties at the individual level. This should be, by definition, "excessive" since it penalizes a non-party. In addition, once the fraud penalty or underpayment penalty applies, there is no mechanism for judicial review of the amount regardless of the innocence of the third party and regardless of whether the penalty will destroy the business, a penalty which is not even dischargeable in bankruptcy.

(2) Is The Application Of the Penalty Excessive As To The Individual Petitioners?

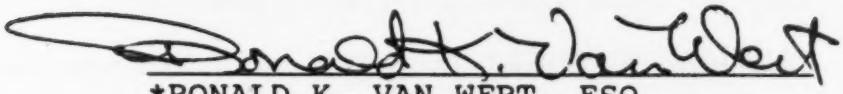
As a result of the duplication of the fraud and other penalties at both the corporate level and the individual level, the penalties and taxes exceed the total amount of Gosen receipts. The penalties bear no relationship to the harm to the COMMISSIONER and do not take into account

any mitigating factor. This penalty should be deemed excessive under the Eighth Amendment and a violation of due process in that there is no mechanism for review of the amount once fraud is found.

CONCLUSION

WHEREFORE, Petitioners respectfully pray that a writ of certiorari be granted.

Respectfully submitted,



*RONALD K. VAN WERT, ESQ.
A Member of Ronald K. Van Wert
A Professional Corporation,
1301 Dove Street, Suite 900
Newport Beach, CA 92660-2448
Telephone: (714) 752-7964

*Counsel of Record for Petitioners ALEXANDER SHOKAI, INC., EDWARD ALEXANDER and ESTELLE ALEXANDER

Dated: January 6, 1995

APPENDIX

LIST OF CONTENTS — PAGE NO.

September 2, 1994, Opinion of the Court of Appeals for the Ninth Circuit..... 40

October 13, 1994, Order of the Court of Appeals for the Ninth Circuit..... 82

January 21, 1992, Memorandum Findings of Fact and Opinion of the United States Tax Court..... 83

January 23, 1992, Order of the United States Tax Court..... 192

July 13, 1992, Decision of the United States Tax Court in case number 16443-89..... 199

July 13, 1992, Decision of the United States Tax Court in case number 16543-89..... 203

July 13, 1992, Decision of the United States Tax Court in case number 18181-89..... 207

FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

ALEXANDER SHOKAI, INC.; EDWARD ALEXANDER; ESTELLE ALEXANDER,	)	
Petitioners-Appellants	)	No. 93-70101
v.	)	T.C. No. 16443-89
COMMISSIONER OF INTERNAL REVENUE SERVICE,	)	**OPINION**
Respondent-Appellee.	)	

Appeal from a Decision of the
United States Tax Court

Argued and Submitted
June 8, 1994--Pasadena, California

Filed September 2, 1994

Before: Jerome Farris,
Diarmuid F. O'Scannlain and
Stephen S. Trott, Circuit Judges

Opinion by Judge Farris

SUMMARY

Tax/Fraud/Income

The court of appeals affirmed a decision of the United States Tax Court. The court held that the record supported the tax court's finding of numerous "badges of fraud," where the Taxpayers underreported their income and failed to keep certain records.

Gosen Co., Ltd., granted appellant Edward Alexander the right to sell its string as a wholesaler in the United States. Alexander's business was incorporated under the name E. Alexander, Inc. (EAI). Alexander was the sole stockholder of EAI. In the early stages of the business, appellant Estelle Alexander, Alexander's wife, performed various duties for EAI. After her duties were curtailed, Estelle received a salary averaging $36,000 per year in 1980,

1981, and 1982.

Gosen agreed to pay EAI a commission on all sales made by Gosen to EAI and to all foreign customers of EAI. A currency exchange agreement was also entered into between EAI and Gosen, providing that if the exchange rate of yen to dollars fluctuated by a certain amount between certain times, Gosen agreed to repay that amount to EAI. Gosen and Alexander also entered into an oral agreement that if the Japanese National Tax Administration (JNTA) disallowed Gosen a deduction for any payment made to Alexander pursuant to the Gosen agreements, he would be required to personally repay Gosen.

Although the written agreements were between EAI and Gosen, the commission and currency fluctuation payments (Gosen payments) were made directly to a Japanese account owned by Alexander. Gosen paid Alexander pursuant to the agreements. Alexander withdrew part of the money from

the account to deposit into his personal bank accounts in the United States.

Alexander described the Gosen payments to retired accountant Kenneth Bartelt. Bartelt's son, Edward Bartelt, was employed to prepare EAI's and the Alexanders' federal income tax returns. Alexander did not inform Edward of the Gosen agreements or payments.

After completing an audit of Gosen in 1984, the JNTA notified the Internal Revenue Service (IRS) of the existence of the Gosen agreements, the Gosen payments, and Alexander's Japanese bank account. Alexander met with Edward Bartelt, and they concluded that the Gosen payments had not accrued as income until the JNTA had finished its 1984 audit, because, until then, Alexander had the contingent obligation to repay Gosen in the event the JNTA disallowed the deductions.

Appellant Alexander Shokai, Inc. (ASI)

was formed in 1982 with Alexander as its sole owner. EAI and ASI merged, with ASI remaining as the surviving corporation. ASI reported the income from the Gosen payments on its 1984 income tax return. The Alexanders reported the income from the Gosen payments on their 1984 joint federal income tax return.

The IRS issued a notice of deficiency to ASI, as successor to EAI. The IRS claimed that EAI had received unreported income from Gosen. At a pretrial calendar call hearing, the only item noticed to be heard was a third party motion to quash a subpoena. The Taxpayers' counsel was excused from attending the hearing. After the tax court ruled on the motion to quash, however, it allowed the Commissioner's counsel to file several documents. In the absence of the Taxpayers' counsel, the tax court and the appellee, the Commissioner of Internal Revenue Service's counsel discussed the

merits of the documents that were filed. The court also inquired as to the status of a deposition.

The tax court agreed with the Commissioner that the Gosen payments constituted gross receipts of EAI which had been diverted by Alexander for personal use. The court ruled that both EAI and Alexander were liable for substantially underreporting income and tax fraud. Estelle was jointly and severally liable for Alexander's penalties. The court also determined that EAI was not entitled to deduct the salary payments to Estelle from 1980--1982.

ASI, Alexander and Estelle appealed the tax court's decision denying them a redetermination of back taxes and penalties asserted by the Commissioner. The Taxpayers contended that the tax court should have granted their motion for a new trial because improper *ex parte* communications took place between the Commissioner's counsel and the

tax court. The taxpayers also contended that the tax court erred in holding that the "claim of right" doctrine applied to the Gosen payments. The Taxpayers further contend that the tax court erred in finding that the underpayment of taxes was due to tax fraud. Finally, the Taxpayers also contended that the tax court erred in disallowing deduction for Estelle's salary.

[1] What should have been limited to a hearing on the motion to quash a subpoena turned into a discussion of the merits of the case. The *ex parte* communications were improper. [2] However, the *ex parte* communications did not taint the trial. The Taxpayers were not unfairly prejudiced.

[3] A taxpayer receives a payment under a claim of right when he treats the payment "as belonging to him." [4] In this case, the Gosen payments bore no resemblance to loans to deposits. Gosen could demand repayment of the Gosen payments from the

Taxpayers only if the JNTA disallowed the deductions. Thus, the tax court correctly ruled that the "claim of right" doctrine applied. [5] The Gosen payments were held under a claim of right from 1980--1983; Alexander freely withdrew money from the account and treated it as his own.

[6] The Taxpayers could not use an unsuccessful legal argument which they first devised in response to the IRS investigation to negate fraudulent intent they might have had from 1980--1983. [7] Alexander did not rely on Kenneth Bartelt's advice that the Gosen payments were not taxable until they were brought to the United States; Alexander failed to report the Gosen payments as income even after he had partially transferred them to accounts in the United States. [8] In addition, the Taxpayers' failure to make a "full" disclosure precluded their reliance on Edward Bartelt's preparation of their tax returns. [9] The

record supported the tax court's finding of numerous badges of fraud; the Taxpayers underreported their income, and the tax court properly found that they failed to keep certain records. [10] The tax court's conclusion that Alexander attempted to conceal the existence of the Gosen payments also found ample support in the record.

[11] The tax court did not clearly err in concluding that the Taxpayers failed to prove that Estelle performed services to the corporation before or during the years in issue that justified characterizing the salary payments as compensation for services rendered.

[12] The Taxpayers also contended that the assessment of fraud penalties against EAI was inconsistent with the Commissioner's finding that Estelle did not commit tax fraud. They argued that Estelle was an "innocent stockholder" of EAI, and therefore fraud should not be imputed to EAI.

[13] However, the "innocent stockholder" defense is not applicable where one individual is the record owner of 100 percent of the taxpayer corporation's stock.

COUNSEL

Ronald K. Van Wert, Newport Beach, California, for the petitioners-appellants.

Sara S. Holderness, Tax Division, United States Department of Justice, Washington, D.C., for the respondent-appellee.

OPINION

FARRIS, Circuit Judge:

Taxpayers Alexander Shokai, Inc., Edward Alexander and Estelle Alexander appeal the decision of the tax court denying them a redetermination of approximately $2 million in back taxes and penalties asserted by the Commissioner. The tax court had jurisdiction under 26 U.S.C. § § 6213, 6214

and 7442. We have jurisdiction pursuant to 26 U.S.C. § 7482, and we affirm.

I. Facts

In the 1960's, Gosen Co., Ltd., a Japanese manufacturer of tennis strings, granted Edward Alexander the right to sell its string as a wholesaler in the United States. The business began in the home of Mr. Alexander and his wife, Estelle Alexander. In the 1970's the business was incorporated under the name E. Alexander, Inc. (EAI), a California corporation. Mr. Alexander was the sole stockholder of EAI.

In the early stages of the business, Mrs. Alexander performed various duties for EAI. After an office assistant was hired in the late 1970's, Mrs. Alexander's duties were sharply curtailed. She nevertheless received a salary averaging $36,000 per year in 1980, 1981 and 1982. The salary payments were deducted from EAI's income.

In 1979, Gosen agreed to pay EAI a 10%

commission on all sales made by Gosen to EAI and to all foreign customers of EAI.[1] A currency exchange agreement was also entered into between EAI and Gosen. Pursuant to this agreement, if the exchange rate of yen to dollars fluctuated by a certain amount from the time Gosen billed EAI to the time EAI paid Gosen, Gosen agreed to repay that amount to EAI.

Gosen and Mr. Alexander also entered into an oral agreement that if the Japanese National Tax Administration ("JNTA") disallowed Gosen a deduction for any payment made to Mr. Alexander pursuant to the Gosen agreements, he would be required to personally repay Gosen. The JNTA completed an audit of Gosen in 1984, at which time it

---

[1]The agreement was amended in 1980. The amendment provided that the 10% sales commission established by the 1979 agreement was to be segregated into a 5% sales commission and a 5% advertising expense reimbursement fee. The tax court found that the amount received for advertising reimbursement was, in substance, a 5% commission payment.

allowed Gosen deductions for the payments it had made to Mr. Alexander.

Although the written agreements were between EAI and Gosen, the commission and currency fluctuation payments (the Gosen payments) were made directly to a Japanese account owned by Mr. Alexander. Between March 4, 1980 and February 28, 1984, Gosen paid Mr. Alexander $944,269.22 pursuant to the commission and currency exchange agreements. From 1980 to 1983, Mr. Alexander withdrew $565,551 from the account to pay for traveling expenses while in Japan and to deposit into his personal bank accounts in the United States.

Mr. Alexander described the Gosen payments to his friend and retired accountant, Kenneth Bartelt. According to Mr. Alexander, Kenneth Bartelt advised him that the payments would not be taxable in the United States unless brought into the United States. Kenneth Bartelt's son, Edward

Bartelt, was employed to prepare EAI's and the Alexanders' federal income tax returns. Mr. Alexander did not inform Edward Bartelt of the Gosen agreements or payments.

None of the Gosen's payments to Mr. Alexander were deposited into EAI's corporate bank account or recorded on EAI's books. None of the payments were reported as income on Mr. Alexander or EAI's federal income tax returns for the 1980--1983 tax years.

After completing its audit of Gosen in 1984, the JNTA notified the IRS of the existence of the Gosen agreements, the Gosen payments and Mr. Alexander's Japanese bank account. After an IRS investigation had begun, Mr. Alexander met with Edward Bartelt and some other financial advisers. They concluded that the Gosen payments had not accrued as income until the JNTA had finished its 1984 audit because, until then, Mr. Alexander had the contingent obligation

to repay Gosen in the event the JNTA disallowed the deductions. Alexander Shokai, Inc., a California corporation, was formed in 1982 with Mr. Alexander as its sole owner. In 1984, EAI and Alexander Shokai, Inc. merged, with Alexander Shokai, Inc. remaining as the surviving corporation. Alexander Shokai, Inc. reported the income from the Gosen payments on its 1984 income tax return. Mr. and Mrs. Alexander reported the income from the Gosen payments on their 1984 joint federal tax return as well.

In 1989, the IRS issued a notice of deficiency to Alexander Shokai, Inc., as successor to EAI. The IRS claimed that EAI had received unreported income from Gosen and that the $36,000 salary paid to Mrs. Alexander from 1980--1982 was improperly deducted. The IRS also maintained that EAI was liable for additions to tax for tax fraud (1980--1983), 26 U.S.C. § 6653(b), and substantially understating income (1982--

1983), 26 U.S.C. § 6651(a).

The IRS sent separate notices of deficiency to Mr. and Mrs. Alexander. It determined that the Gosen payments were gross receipts of EAI which had been diverted by Mr. Alexander for his own use and maintained that Mr. Alexander was liable for additions to tax for substantially understating income (1982--1983) and for tax fraud (1980--1983). Mrs. Alexander was not implicated in the alleged tax fraud.

The tax court agreed with the Commissioner that the Gosen payments constituted gross receipts of EAI which had been diverted by Mr. Alexander for personal use. The tax court ruled that both EAI and Mr. Alexander were liable for substantially underreporting income and tax fraud (Mr. Alexander's fraud was imputed to EAI). Mrs. Alexander was jointly and severally liable for Mr. Alexander's penalties pursuant to 26 U.S.C. § 6013(d)(3). The tax court deter-

mined that EAI was not entitled to deduct the $36,000 salary payments to Mrs. Alexander from 1980--1982.

II. The *Ex Parte* Communications

Taxpayers argue that the tax court should have granted their motion for a new trial because improper *ex parte* communications took place between Commissioner's counsel and the tax court. We review facts that may have deprived Taxpayers of a fair trial *de novo*. United States v. Milner, 962 F. 2d 908 (9th Cir.), cert. denied, 113 S. Ct. 614 (1992). We have held that *ex parte* communications will be tolerated only in light of a "compelling justification." Guenther v. Commissioner, 939 F. 2d 758, 760 (9th Cir. 1991). To determine whether Taxpayers' due process rights were violated, we must determine whether Taxpayers were "unfairly prejudiced" by the *ex parte* communications. Id.

The *ex parte* communications Taxpayers

complain of occurred on December 10, 1990 during a pretrial calendar call hearing. The only item noticed to be heard was a third party motion to quash a subpoena served by the Commissioner. Taxpayers' counsel was excused from attending the hearing.

Some of the discussions at the hearing related to the motion to quash. Those discussions were not improper because Taxpayers opted not to attend the hearing knowing that the tax court would rule on that motion.

However, after the tax court had ruled on the motion to quash, it allowed the Commissioner's counsel to file several documents, including (1) a motion in limine, (2) an opposition to Taxpayers' motion in limine, and (3) a motion to compel document production. In the absence of Taxpayers' counsel, the tax court and the Commissioner's counsel proceeded to discuss the

merits of the documents that were filed. The tax court also inquired as to the status of the Commissioner's deposition of Yutaka Takashima, Gosen's president. The Commissioner's counsel responded that he felt as though he was being "stonewalled" by Gosen. Finally, the Commissioner's counsel informed the tax court that he was having serious problems reaching factual stipulations with Taxpayers' counsel. The tax court expressly stated that it would not make any rulings until Taxpayers' counsel could be heard.

[1] We have carefully reviewed the record. What should have been limited to a hearing on the motion to quash a subpoena turned into a discussion of the merits of the case. The *ex parte* communications were improper. We must determine whether Taxpayers were "unfairly prejudiced."

In Guenther, the Commissioner's counsel filed a 32 page memorandum with the tax court without serving it on or disclosing it

to taxpayers' counsel. The memorandum was highly partisan, alleging misconduct on the part of taxpayers and criticizing taxpayers' anticipated trial testimony. See Guenther, 939 F. 2d at 760. We held that taxpayers were unfairly prejudiced because (1) "[t]he allegations raised [in the memorandum] were serious, going both to the merits of the case and to the Guenthers' character generally" and (2) the Guenthers did not have "an adequate opportunity to rebut the contentions effectively." Id. at 761.

[2] The communications in this case were less egregious than those in Guenther. Taxpayers were served with every document filed with the tax court in their absence. The tax court expressly stated it would not rule on any of the motions until Taxpayers had a chance to respond. Taxpayers had an adequate opportunity to respond at trial. Our review of the trial transcript convinces us that the *ex parte* communications did not

taint the trial. Although the *ex parte* communications were improper, we find that Taxpayers were not unfairly prejudiced.

III. Attacks on Taxpayers' Counsel

Taxpayers contend that the tax court and Commissioner's counsel improperly attached the integrity of Taxpayers' counsel. They argue that the tax court should have exercised more control over Commissioner's counsel. They also point to numerous adverse rulings by the tax court as evidence that the judge had become "an advocate" for the Commissioner.

The manner in which a judge conducts a trial is reviewed under an abuse of discretion standard. Hansen v. Commissioner, 820 F. 2d 1464, 1467 (9th Cir. 1987). "[A] clear and precise showing of prejudice must be made to demonstrate judicial misconduct, particularly in noncriminal trials." Id. None of the incidents to which Taxpayers refer establish judicial misconduct.

IV. Claim of Right Doctrine

Taxpayers argue that the tax court erred in holding that the "claim of right" doctrine applied to the Gosen payments. Instead, Taxpayers contend that the tax court should have applied the "complete dominion" test set forth in Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990). Whether the "complete dominion" test or the "claim of right" doctrine applies is a question of law reviewed de novo. Pacific First Fed. Sav. Bank v. Commissioner, 961 F. 2d 800, 803 (9th Cir.), cert. denied, 113 S. Ct. 209 (1992).

In Indianapolis Power, the Court was faced with the issue of whether utility companies that required deposits of their less creditworthy customers had to report those deposits as income. The Court ruled that the deposits were more similar to loans, and thus not reportable as income. The Court reasoned that "[t]he customer who

submits a deposit to the utility, like [a] lender . . . retains the right to insist upon repayment in cash . . . and the utility therefore acquires no unfettered 'dominion' over the money at the time of receipt." Indianapolis Power, 493 U.S. at 212. It was in the context of distinguishing deposits from advance payments for goods and services that the Court stated that "the crucial point is not whether [the taxpayer's] use of the funds is unconstrained during some interim period. The key is whether the taxpayer has some guarantee that he will be allowed to keep the money." Id. at 210.

[3] The "claim of right" doctrine, asset forth in North American Oil Consolidated v. Burnet, 286 U.S. 417, 424 (1932):

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to [report],

> even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

See also Butchko v. Commissioner, 638 F. 2d 1214, 1216 n. 5 (9th Cir. 1981). A taxpayer receives a payment under a claim of right when he treats the payment "as belonging to him." Healy v. Commissioner, 345 U.S. 278, 282 (1953). If the taxpayer is eventually required to repay all or part of the earnings in a later year, he is entitled to an offsetting deduction for the year in which repayment is made. North American Oil, 286 U.S. at 424.

[4] Indianapolis Power is readily distinguishable. In Indianapolis Power, the utilities had an absolute obligation to repay the deposits to their customers if a request for repayment was made; thus, the Commissioner could not have even argued that

the utility companies held the deposits under a "claim of right." In contrast, the Gosen payments bore no resemblance to loans or deposits. Gosen could demand repayment of Gosen payments from Taxpayers only if the JNTA had disallowed the deductions. The tax court correctly ruled that the "claim of right" doctrine was applicable.

[5] Having concluded that the tax court applied the correct test, we review its conclusion that the Gosen payments were held under a "claim of right" for abuse of discretion. Cf. Commissioner v. Duberstein, 363 U.S. 278, 291 (1960) (reviewing court's conclusion of what constituted a "gift" for clear error). We find none. Mr. Alexander freely withdrew money from the account and treated it as his own. The Gosen payments were held under a claim of right from 1980--1983.

V. Tax Fraud

Taxpayers argue that the tax court

erred in finding that the underpayment of taxes was due to tax fraud. the tax court's finding of fraud is factual and will be reversed only if we are "left with the definite and firm conviction . . . that there is no clear and convincing evidence of fraud." Bradford v. Commissioner, 796 F. 2d 303, 307 (9th Cir. 1986) (citations omitted).

A. Finding Fraud Where An Issue Is Not Free From Doubt

Taxpayers argue that a finding of fraud is precluded because they made a good faith, non-frivolous argument regarding the applicability of the "complete dominion" test. Taxpayers rely on United States v. Dahlstrom, 713 F. 2d 1423, 1428 (9th Cir. 1983), cert. denied, 466 U.S. 980 (1984), a criminal tax fraud case, where we held that "when the law . . . is highly debatable, a defendant--actually or imputedly--lacks the requisite intend to violate it."

[6] Taxpayers' reliance on Dahlstrom is misplaced. Taxpayers have pointed to no evidence in the record showing that they relied on the "complete dominion" test during the years that they failed to report the Gosen payments. Instead, Mr. Alexander testified that he relied on Kenneth Bartelt's advice that the Gosen payments were not taxable until they were brought into the United States (though he did not heed that advice). Taxpayers may not use an unsuccessful legal argument which they first devised in response to the IRS investigation to negate fraudulent intent they might have had from 1980--1983. Cf. Zell v. Commissioner, 763 F. 2d 1139, 1142 (10th Cir. 1985) ("Fraud means actual, intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing." (emphasis added) (quotations omitted)).

B. Subjective v. Objective Test

Taxpayers next contend that the tax court applied an objective rather than subjective standard as to the reasonableness of Mr. Alexander's belief that no taxes were due. We reject the argument. Nothing in the record indicates that the tax court applied an "objective" standard. The tax court specifically stated that the Commissioner had to show by "clear and convincing evidence that the taxpayer intended to evade paying taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of taxes." (emphasis added).

C. Reliance On Financial Advisers

Taxpayers contend that they relied on the advice of their financial advisers, Kenneth and Edward Bartelt. A taxpayer may rebut the Commissioner's proof of fraud by showing that he relied in good faith on his accountant's advice after "full disclosure

of tax related information." United States v. Claiborne, 765 F. 2d 784, 798 (9th Cir. 1985) (emphasis added), cert. denied, 475 U.S. 1120 (1986).

[7] Kenneth Bartelt advised Taxpayers that the Gosen payments were not taxable until they were brought to the United States. We agree with the tax court that Mr. Alexander did not rely on that advice because he failed to report the Gosen payments as income even after he had partially transferred them to accounts in the United States.

[8] Taxpayers also contend that they properly relied on Edward Bartelt's expertise in preparing their tax returns. Although Taxpayers made their U.S. bank records available to Edward Bartelt, they failed to disclose the Gosen payments, the Gosen agreements or the oral contingent agreement to him. Taxpayers failure to make a "full" disclosure precludes their reliance

on Edward Bartelt's preparation of their tax returns. See Claiborne, 765 F. 2d at 798 ("[A] defendant cannot shift his responsibility for deficiencies to an accountant if the defendant has withheld vital information . . . .").

D. Clear and Convincing Evidence of Fraud

Taxpayers assert that there was no clear and convincing evidence of tax fraud. Because tax fraud is rarely established by direct evidence, fraudulent intent can be inferred from circumstantial evidence. See Bradford, 796 F. 2d at 307. Badges of fraud include understatements of income, failure to maintain adequate records, implausible or inconsistent explanations of behavior, concealment of assets, and failure to cooperate with tax authorities. Id.

[9] The record supports the tax court's finding of numerous badges of fraud. Taxpayers underreported their income during

the years in question. In addition, the tax court properly found that Taxpayers failed to keep records of the amounts earned or received from Gosen.

[10] The tax court's conclusion that Mr. Alexander attempted to conceal the existence of the Gosen payments also finds ample support in the record. Mr. Alexander failed to inform Mrs. Alexander, Edward Bartelt, and EAI's corporate staff of the existence of the Gosen payments and the Japanese account. Only Gosen and Kenneth Bartelt were aware of the existence of the account. Further, when Mr. Alexander transferred money from the account to the United States he did so by withdrawing cashier's checks in the amount of $4,000 and sending them in separate envelopes to his home. A U.S. Customs regulation requires persons bringing sums of money in excess of $5,000 into the United States to fill out a disclosure form. See 31 U.S.C. § 5316. The tax

court could properly infer that Mr. Alexander intended to conceal the transfers by avoiding U.S. Customs disclosure requirements.

The tax court also correctly concluded that Mr. Alexander had provided inconsistent explanations for his behavior. Mr. Alexander's reliance on Kenneth Bartelt's advice that the Gosen payments were not taxable if they remained in Japan was inconsistent with Mr. Alexander's failure to report the payments once he had transferred them to the United States.

E. Factors Disproving Fraud

Taxpayers argue that the tax court disregarded numerous factors tending to disprove fraud. For example, Mr. Alexander maintains that the cooperated with the IRS. The record contradicts this assertion. For example, Freeman Harris, an IRS agent assigned to investigate the case, testified that Mr. Alexander informed him in July 1984

that the "majority" of the Gosen payments remained in Japan and that the income from the Gosen payments had been reported. Neither of these statements were accurate.

Mr. Alexander also contends that he provided leads to the IRS for the purpose of verifying his account on what took place, and that the IRS failed to follow up on those leads as required by Edelson v. Commissioner, 829 F. 2d 828, 831 (9th Cir. 1987). Mr. Alexander fails to specify what those leads were, and how they would have exonerated him. The other factors he lists as tending to "disprove" fraud are not relevant with respect to whether he committed tax fraud in the United States.

VI. Exclusion of Taxpayers' Expert From Courtroom

Taxpayers argue that the tax court erred in excluding their accounting expert from the trial. We review the tax court's decision to exclude a witness from being

present in the courtroom under Tax Court Rule 145 (which mirrors Fed. R. Evid. 615) for abuse of discretion. Cf. Breneman v. Kennecott Corp., 799 F. 2d 470, 472 (9th Cir. 1986) (decision not to exclude witness from trial under Fed. R. Evid. 615 reviewed for abuse of discretion). An erroneous decision is cause for reversal only if it is prejudicial. Id. at 474.

Tax Court Rule 145 does not authorize exclusion of "a person whose presence is shown by a party to be essential to the presentation of such party's cause." Id. Taxpayers have not shown that the presence of their expert was necessary for presentation of their case, nor have they established prejudice.

VII. Evidentiary Rulings

Taxpayers argue that the tax court erred in (1) failing to admit the deposition of Yutaka Takashima, Gosen's president, (2) failing to consider documentary proof

that Edward Bartelt had been provided with Taxpayers' U.S. bank account balances, (3) failing to consider the testimony of their expert Michael Christianson, (4) admitting a letter from the JNTA to the Commissioner and (5) failing to rule on the admissibility of various exhibits.

Evidentiary rulings are reviewed for abuse of discretion. Hudspeth v. Commissioner, 914 F. 2d 1207, 1213 (9th Cir. 1990). Erroneous evidentiary rulings do not warrant reversal in the absence of prejudice. Roberts v. College of the Desert, 870 F. 2d 1411, 1418 (9th Cir. 1988).

We have carefully reviewed the record and find no abuse of discretion. Taxpayers have also failed to establish prejudice.

VIII. Mrs. Alexander's Salary

Taxpayers assert that it was permissible for EAI to pay Mrs. Alexander for past services and that the tax court erred in disallowing deductions for her salary. The

tax court's finding that the $36,000 salary was not reasonable compensation is a factual finding reviewed for clear error. Nor-Cal Adjusters v. Commissioner, 503 F. 2d 359, 362 (9th Cir. 1974).

[11] "It is permissible to pay and deduct compensation for services performed in prior years." Elliotts, Inc. v. Commissioner, 716 F. 2d 1241, 1248 (9th Cir. 1983), so long as the compensation is reasonable in amount, Lewis and Taylor, Inc. v. Commissioner, 447 F. 2d 1074, 1078 (9th Cir. 1971). Taxpayers appear to contend that since Mrs. Alexander's replacement was paid more than she was, the salary payments made to her during the years at issue for her prior services were reasonable. However, the fact that EAI paid Mrs. Alexander's replacement a higher salary does not mean that Mrs. Alexander was undercompensated while she was working. The tax court did not clearly err in concluding that Taxpayers

had "failed to prove that Mrs. Alexander performed any services to the corporation during or prior to the years in issue that would justify characterizing the payments" as compensation for services rendered.

IX. Diversion Of Income

Taxpayers argue that Alexander Shokai, Inc. (EAI's successor corporation) is not liable for taxes or penalties stemming from the Gosen payments because the Gosen payments did not constitute corporate income. They argue that Gosen and Mr. Alexander intended that the Gosen payments be outside the range of EAI's corporate transactions. The record supports the tax court's conclusion that the Gosen agreements were between EAI and Gosen, and that Gosen payments should be attributable as income to EAI. Each of the Gosen agreements were entered into between EAI and Gosen, with Mr. Alexander signing the agreements in his capacity as president of EAI. The commissions were

based on sales of tennis string by EAI. Further, EAI's 1983 income tax return noted that all of the income obtained from the Gosen payments constituted corporate income.

Taxpayers also argue that Mr. Alexander's fraud cannot be imputed to EAI because he was not acting on behalf of the corporation. See Asphalt Indus. v. Commissioner, 384 F. 2d 229, 233 (3d Cir. 1967). We reject the argument. Mr. Alexander was acting on behalf of, and not against, the interests of EAI. The Gosen agreements were beneficial to both Mr. Alexander and EAI because, by committing tax fraud, Mr. Alexander increased EAI's wealth. See Ruidoso Racing Ass'n v. Commissioner, 476 F. 2d 502, 507 (10th Cir. 1973). Even though Mr. Alexander diverted EAI's corporate income for his own use, such a diversion was not "antagonistic" to EAI since Mr. Alexander was taking money that would otherwise have been available to him as dividends. See

American Lithofold Corp. v. Commissioner, 55 T.C. 904, 926 (1971).

Mr. Alexander's fraud was properly imputed to EAI.

X. Reconciliation Of Fraud Penalty With Commissioner's Determination That Mrs. Alexander Failed To Participate In The Fraud

[12] Taxpayers argue that the assessment of fraud penalties against EAI was inconsistent with the Commissioner's finding that Mrs. Alexander did not commit tax fraud. In Asphalt Indus., the Third Circuit refused to impute the fraud of a 50% stockholder to a corporation where the other 50% stockholder was innocent of any wrongdoing. The court reasoned that the innocent stockholder was as much defrauded as the government, "and it would be piling additional injury upon an innocent stockholder to require that the corporation in which he invested should bear the burden of assessments based upon the fraud" of the other

stockholder. 384 F. 2d at 235. Although Mr. Alexander was the record owner of 100% of the stock, Taxpayers argue that under California community property law, Mrs. Alexander had an equal interest in Mr. Alexander's stock. See Cal. Civ. Code § § 5105, 5110. thus, they conclude, Mrs. Alexander was an "innocent" stockholder of EAI, and, under the doctrine of Asphalt Indus., fraud should not be imputed to EAI.

[13] We have not adopted the "innocent stockholder" defense in this circuit, and we decline to do so now. Taxpayers' expansive interpretation of Asphalt Indus. would encourage tax fraud by the 100% record owners of closed corporations who happened to be married. We are persuaded by the reasoning of the Tenth Circuit in Ruidoso Racing Ass'n., where the court explained that "[p]rotection of innocent shareholders . . . may not be an appropriate concern so long as the other elements necessary to

impute fraud to the corporation are present." 476 F. 2d at 507. We hold that the "innocent stockholder" defense articulated in Asphalt Indus. is not applicable where one individual is the record owner of 100% of the taxpayer corporation's stock.[2]

XI. Liability Of Alexander Shokai, Inc.

Finally, Taxpayers contend that Alexander Shokai, Inc. should not incur liability for any additions to tax or penalties because it is the successor corporation to EAI. Section 6901 of the Internal Revenue Code provides that the income tax liability of a transferor of property is assessed against the transferee "in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred." 26 U.S.C. § 6901(a)(1). Contrary

---

[2]We leave for another day the question of whether the innocent stockholder defense may be invoked under more appropriate circumstances.

to Taxpayers' contention, a transferee's income tax liability includes any additions or penalties that have been assessed against the transferor. See 26 U.S.C. § 6662(a)(2) ("Any reference to 'tax' imposed by this title shall be deemed also to refer to additions to the tax, additional amounts, and penalties provided by this chapter.") Lee Optical Associated Cos. Pension Plan & Trust v. Commissioner, T.C. Memo 1989-152 (1989) (transferee liable for deficiencies and additions to tax for fraud under § 6901(a)).

AFFIRMED

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

ALEXANDER SHOKAI, INC.; EDWARD ALEXANDER; ESTELLE ALEXANDER,	)	FILED OCTOBER 13, 1994
Petitioners-Appellants,	)	No. 93-70101
v.	)	Tax Ct. No. 16443-89
COMMISSIONER OF INTERNAL REVENUE SERVICE,	)	
Respondent-Appellee.	)	ORDER

Before: FARRIS, O'SCANNLAIN and TROTT, Circuit Judges

The panel has voted to deny appellants' petition for rehearing and to reject the suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc and no active judge has requested a vote on whether to rehear the matter en banc. Fed. R. App. P. 35.

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

T.C. Memo 1992-41

UNITED STATES TAX COURT

ALEXANDER SHOKAI, INC., ET AL.,[1]
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket Nos. 16443-89, 16543-89
18181-89

Filed January 21, 1992.
Served January 21, 1992.

Ronald K. Van Wert, for petitioners.

Louis B. Jack, Thomas Travers, and Jerry Gartside, for respondent

MEMORANDUM FINDINGS OF FACT AND OPINION

WRIGHT, Judge: In these consolidated cases, respondent determined deficiencies in and additions to petitioners' Federal income tax as follows:

---

[1]Cases of the following petitioners are consolidated herewith: Edward Alexander, docket No. 16543-89; and Estelle Alexander, docket No. 18181-89.

Docket No. 16443-89--ALEXANDER SHOKAI, INC.

Year	Deficiency	Additions to Tax			
		Sec. 6651(a)(1)	Sec. 6653(b)/ 6653(b)(1)	Sec. 6653(b)(2)	Sec. 6661
2/28/81	$129,034		$ 71,913		
2/28/82	101,426		67,627		
2/28/83	133,215	$33,108	[1]78,428	[2]	$33,304
2/28/84	135,900	36,001	[1]122,393	[2]	33,975

[1]Alternative to the fraud additions, respondent determined additions to tax for negligence as follows: 2/28/83--$7,843 pursuant to sec. 6653(a)(1) and 50 percent of the interest on the portion of the underpayment attributable to negligence or intentional disregard of rules and regulations pursuant to sec. 6653(a)(2); 2/28/84--$12,239 pursuant to sec. 6653(a)(1) and 50 percent of the interest on the underpayment attributable to negligence or intentional disregard of rules and regulations pursuant to sec. 6653(a)(2).

[2]50 percent of the interest due on the portion of the underpayment attributable to fraud.

Docket No. 16543-89--EDWARD ALEXANDER

Year	Deficiency	Additions to Tax		
		Sec. 6653(b)/ 6653(b)(1)	Sec. 6653(b)(2)	Sec. 6661
1980	$133,564	$ 66,782		
1981	159,630	79,815		
1982	127,993	[1]63,996	[2]	$31,998
1983	132,081	[1]66,040	[2]	33,020

[1]Alternative to the fraud additions, respondent determined additions to tax for negligence as follows: 1982--$6,400 pursuant to sec. 6653(a)(1) and 50 percent of the interest on the underpayment attributable to negligence or intentional disregard of rules and regulations pursuant to sec. 6653(a)(2); 1983--$6,604 pursuant to sec. 6653(a)(1) and 50 percent of the interest on the portion of the underpayment attributable to negligence or intentional disregard of rules and regulations pursuant to sec. 6653(a)(2).

[2]50 percent of the interest due on the portion of the underpayment attributable to fraud.

Docket No. 18181-89--ESTELLE ALEXANDER

Year	Deficiency	Additions to Tax		
		Sec. 6653(a)(1)	Sec. 6653(a)(2)	Sec. 6661
1982	$127,993	$6,400	[1]	$31,998
1983	$132,081	6,604	[1]	33,020

[1]50 percent of the interest due on the portion of the underpayment attributable to negligence or intentional disregard of rules and regulations.

The issues for decision are as follows:

(1) For the taxable years ended February 28, 1981, through February 28, 1983, whether E. Alexander, Inc., properly deducted as "Officer's Salary" the amounts it paid to Mrs. Alexander. We hold that the corporation improperly deducted these amounts.

(2) Whether the amounts E. Alexander, Inc., paid to Mrs. Alexander were properly reported in the Alexanders' income as salary income in the taxable years 1981 through 1983. We hold that the Alexanders should have reported this income as dividend income rather than salary income as determined by respondent.

(3) For the taxable years ended February 28, 1981, through February 28, 1984, whether E. Alexander, Inc., properly deducted its expenses attributable to the corporate-owned Mercedes Benz used by Mrs. Alexander. We hold that the corporation

improperly deducted these expenses.

(4) Whether E. Alexander, Inc., properly claimed an investment tax credit in the taxable year ended February 28, 1981, on its purchase of the corporate-owned Mercedes used by Mrs. Alexander. We hold that the corporation improperly claimed this investment tax credit.

(5) Whether the Alexanders should have included the value of Mrs. Alexander's use of this corporate-owned Mercedes in their income in the taxable years 1980 through 1983. We hold that the Alexanders should have included the value of Mrs. Alexander's use of this automobile in their income as dividend income.

(6) Whether E. Alexander, Inc., and/or the Alexanders received unreported income from Gosen Co., Ltd., in the taxable years in issue. We hold that both E. Alexander, Inc., and the Alexanders received unreported income from Gosen Co., Ltd.

(7) Whether E. Alexander, Inc., and the Alexanders should have reported this income upon receipt by Mr. Alexander. We hold that they should have reported this income upon receipt by Mr. Alexander.

(8) Whether Mr. Alexander fraudulently intended to evade paying taxes known to be owing in the taxable years 1980 through 1983. We hold that Mr. Alexander fraudulently intended to evade paying taxes known to be owing in these taxable years.

(9) Whether Mr. Alexander can use the defense of reasonable reliance on an accountant to rebut respondent's proof of fraud in the taxable years 1980 through 1983. We hold that Mr. Alexander cannot use this defense for these taxable years.

(10) Whether E. Alexander, Inc., fraudulently intended to evade paying taxes known to be owing in the taxable years ended February 28, 1981, 1982, and 1983. We hold that the corporation fraudulently intended

to evade paying taxes known to be owing in these taxable years.

(11) Whether E. Alexander, Inc., can use the defense of reasonable reliance on an accountant to rebut respondent's proof of fraud for the taxable years ended February 28, 1982, 1982, and 1983. We hold that the corporation cannot use this defense for these taxable years.

(12) Whether E. Alexander, Inc., fraudulently intended to evade paying taxes known to be owing in the taxable year ended February 28, 1984, in light of its reliance on the advice of its tax advisers pertaining to the income in question. We hold that the corporation reasonably relied on the advice of its tax advisers and, thus, did not file a fraudulent return for the taxable year ended February 28, 1984.

(13) Whether the statute of limitations bars the assessment and collection of the deficiencies and additions to tax set forth

in respondent's notices of deficiency to E. Alexander, Inc., Mr. Alexander, and Mrs. Alexander. We hold the statutes of limitations are open in accordance with this opinion.

(14) Whether E. Alexander, Inc., is liable for the additions to tax pursuant to sections 6651(a)(1)[2] and 6661 determined against it for the taxable years ended February 28, 1983, and February 28, 1984. We hold that the corporation is liable for such additions to tax in accordance with this opinion.

(15) Whether Mr. Alexander is liable for the additions to tax pursuant to sections 6661 determined against him for the taxable years 1982 and 1983. We hold that Mr. Alexander is liable for such additions

---

[2]Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

to tax in accordance with this opinion.

(16) Whether Mrs. Alexander is liable for the additions to tax determined against her for the taxable years 1982 and 1983. We hold that Mrs. Alexander is liable for additions to tax in accordance with this opinion.

(17) Whether Alexander Shokai, Inc., is primarily liable for the deficiencies and additions to tax of E. Alexander, Inc., or whether Alexander Shokai, Inc., is liable only as a "transferee" within the meaning of section 6901. We hold that Alexander Shokai, Inc., is primarily liable for E. Alexander, Inc.'s deficiencies and additions to tax.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated in this opinion. Mr. and Mrs. Alexander resided in Laguna Beach, California, when

they filed their petitions. Alexander Shokai, Inc., had its principal place of business in Irvine, California, when it filed its petition.

Mr. and Mrs. Alexander's Tax Returns

Mr. and Mrs. Alexander filed joint individual income tax returns for the calendar years 1980 through 1983. On these tax returns, the Alexanders reported the following amounts as gross income: $344,601 in 1980, $219,546 in 1981, $251,603 in 1982, and $284,810 in 1983. For each of these years, their tax returns were based upon the cash basis method of accounting.

Mr. Alexander's Tax Knowledge

Mr. Alexander never graduated from high school. (Hereinafter, all references to petitioner in the singular will refer to Mr. Alexander.) Petitioner never received any formal training in accounting, bookkeeping, or the preparation of tax returns. He claimed he never prepared any corporate or

individual tax returns, but instead submitted all the necessary information to his personal/corporate accountant who then prepared the tax returns. Petitioner claims he did not review the returns prepared by the accountant. Petitioner claims that he never participated in classifying any deductions on his personal or corporate tax returns and that he was ignorant "as far as tax business."

Sometime in the seventies or early eighties, petitioner and his accountant discussed forming a domestic international sales corporation to defer paying tax on the export of U.S.-made merchandise. At some point, they also discussed the tax advantages of purchasing municipal bonds. In 1984, he had a meeting with his attorney in which they discussed the potential of forming a foreign corporation to avoid paying U.S. taxes on foreign-earned income. At this meeting, they specifically discussed

using a controlled foreign corporation, the attribution rules of subchapter F, and the availability of low tax rates in lesser-developed countries.

E. Alexander, Inc.

For each of the years in issue, petitioner was the president and sole stockholder of record of E. Alexander, Inc. (EAI), and Mrs. Alexander was the corporate secretary. EAI was a California corporation. During the years in issue, EAI was in the business of importing tennis racket strings for resale to companies in the United States. For each of the years in issue, EAI recorded its income and expenses on the cash basis method of accounting and accounted for and reported Federal income tax on the basis of a fiscal year ending February 28. (For simplicity, the fiscal years of the corporation for the years ended February 28, 1981, 1982, 1983, and 1984 will hereinafter be referred to as the taxable

years 1980, 1981, 1982, and 1983, respectively.)

EAI timely filed its corporate income tax returns for the taxable years 1980 through 1983. After a reduction for income taxes, the corporation had net earnings of $58,944, $81,735, $70,038 and $131,858 for the taxable years 1980 through 1983, respectively. The corporation paid no dividends in any of these years. The corporation had one banking account into which all its gross receipts were deposited.

Salary Expense

When petitioner began his importing business, he operated it out of his home with the assistance of Mrs. Alexander. Mrs. Alexander lent the corporation money, answered telephones, typed letters and invoices, talked to customs brokers, signed checks and the corporate minutes, and advised petitioner on the quality of imported tennis apparel.

Petitioner moved the business out of his home in the late seventies. At this time, he hired Mr. Ritzman to replace Mrs. Alexander. Mr. Ritzman was subsequently replaced in March 1983 by Mr. Ziegler. Mr. Ritzman and Mr. Ziegler were both office managers of EAI. As such, their duties consisted of depositing all corporate receipts into the corporate bank account, answering the phone, opening mail, invoicing customers, paying corporate expenses, signing corporate checks, and forwarding all income and expense information to the corporate accountant for entry into the corporate books.

Petitioners never clearly enunciated the duties, if any, that Mrs. Alexander performed for the corporation after Mr. Ritzman's arrival. It is clear that she no longer came into the office and was no longer actively involved in the business. Mrs. Alexander's business activity was

minimal and consisted of occasionally forwarding messages to petitioner when he traveled overseas three or four times a year.

In 1980, 1981, and 1982, EAI paid Mrs. Alexander $36,000 annually and classified such payments as "Officer's Salary". EAI's accountant determined the amount of her compensation, and petitioner concurred in this determination. The accountant, Mr. E. Bartelt, claims that some of these payments to Mrs. Alexander represented compensation for past services rendered by her. The corporation deducted the $36,000 annual payments under the category of "Officer's Salaries" on its Federal corporate income tax returns for taxable years 1980, 1981 and 1982. On their individual tax returns for 1980 through 1982, the Alexanders reported $46,000, $26,000, and $62,000, respectively, as salary income earned by Mrs. Alexander from EAI.

Corporate-Owned Automobile

On May 23, 1980, EAI purchased a Mercedes Benz for $35,389. Mrs. Alexander used this Mercedes in 1980, 1981, 1982, and 1983. The parties stipulated that petitioner used the car on occasion during these years. For these years, EAI deducted depreciation on the Mercedes and paid and deducted the Mercedes' insurance and license fee. In the taxable year 1980, EAI claimed an investment ax credit of $3,539 with respect to its 1980 purchase of the Mercedes. The Alexanders did not include the value of Mrs. Alexander's use of this automobile as income on their joint tax returns for 1980 through 1983.

Merger of E. Alexander, Inc., and Alexander Shokai, Inc.

Alexander Shokai, Inc. (Shokai), a California corporation, was incorporated in 1982. Throughout the taxable years in issue, petitioner was its president and sole

shareholder. On January 26, 1984, EAI and Shokai entered an "Agreement of Merger (And Plan of Reorganization)". Pursuant to this merger agreement, EAI became the "disappearing corporation", and Shokai became the "survivor corporation". As the survivor corporation, Shokai became subject to all of EAI's debts and liabilities "as if it had itself incurred them". The tax liabilities in issue arose in the taxable years of EAI.

The merger of EAI and Shokai was consummated under the provisions of chapter 11 of the California Corporations Code. Section 1107 of chapter 11 provides that a surviving corporation in a merger pursuant to chapter 11 is subject to all the debts and liabilities of the disappearing corporation in the same manner as if the surviving corporation had itself incurred them. Cal. Corp. Code sec. 1107 (West 1990).

Gosen Agreements and Gosen Payments

Gosen Co., Ltd. (Gosen), of Osaka, Japan, manufactures tennis racket string. During each of its taxable years 1980 through 1983, EAI purchased Gosen's string for resale in the United States.

On March 30, 1979, Gosen executed a written agreement entitled "General Sales Agreement Between E. Alexander, Inc., U.S.A. and Gosen Co., Ltd., Osaka Japan". Pursuant to this agreement, EAI became Gosen's exclusive U.S. sales agent. EAI also became entitled to receive a 10-percent sales commission on all string it purchased from Gosen. Petitioner signed this document as president of EAI.

On December 30, 1980, the March 30, 1979, agreement was amended by another written agreement entitled "Sole Agency Agreement". This agreement was entered into between Gosen and EAI. Again, petitioner signed this agreement as president of EAI.

Pursuant to this agreement, the 10-percent sales commission was segregated as a 5-percent sales commission and a 5-percent advertising expense reimbursement fee. The National Japanese Taxing Authority (NTA) suggested that the 10-percent commission payments be segregated in this matter. EAI never did any advertising for Gosen; instead, the amounts were merely classified as advertising. We find the 5 percent received as advertising expense reimbursement fees was in substance a 5-percent commission payment.

On May 2, 1979, Gosen executed another written agreement entitled "The Return of Excess Proceeds in Japanese Yen by the Foreign Exchange Rate of Yen to U.S. Dollars". This agreement was addressed to "E. Alexander, Inc.", from Gosen and was signed by petitioner. The purpose of this agreement was to protect both corporations from fluctuations in the yen on EAI's

purchases of Gosen string. Apparently Gosen billed EAI in yen, and EAI paid in dollars. If the exchange rate of yen to dollars increased from the time Gosen billed EAI to the time EAI paid Gosen, EAI would have overpaid Gosen. This final agreement provided that if the exchange rate for yen exceeded a certain amount against the dollar, Gosen would repay the additional amounts to EAI. This agreement also protected Gosen if the exchange rate of yen to dollars decreased.

Hereinafter, the above referenced agreements will be referred to collectively as the Gosen agreements, and the payments for sales commissions (which include the advertising reimbursement fees) and currency fluctuations will be referred to collectively as the Gosen payments.

Mr. Kiyoshi Matsuo was involved in the execution of each of the Gosen agreements and was the head of the export-import

department of Gosen at these times. Mr. Matsuo testified that all the Gosen agreements were between Gosen and EAI. He further testified that the commission payments were based on the amount of string EAI purchased from Gosen. Petitioner also testified that the Gosen agreements were between Gosen and EAI and that the commission payments were based on sales made to EAI.

During the years in issue, none of the Gosen payments were recorded on EAI's corporate books as its income, and none were deposited into EAI's corporate bank account. Instead, all but two of the payments were deposited into an individual checking account opened by Petitioner in 1974 at the Bank of America in Osaka, Japan (Osaka account). The first two Gosen payments were made by remittances to petitioner from Gosen. Thereafter, at the request of the NTA that Gosen make the payments by bank

transfers, Gosen electronically wired the payments from its bank account to petitioner's Osaka account. Petitioner directed the payments to be sent to his Osaka account. Bank records indicate Gosen paid petitioner $944,269.22 between March 4, 1980, and November 28, 1983, as follows:

Date of Payment	Amount of Payment
March 4, 1980	[1]$44,079.46
March 4, 1980	[1]20,000.00
June 18, 1980	60,557.22
November 12, 1980	35,000.00
November 12, 1980	25,000.00
January 14, 1981	47,346.14
April 21, 1981	55,000.00
August 18, 1981	15,000.00
August 18, 1981	45,000.00
December 3, 1981	60,000.00
March 12, 1982	60,954.86
April 21, 1982	50,000.00
August 19, 1982	56,331.54
November 30, 1983	40,000.00

November 30, 1983	40,000.00
May 6, 1983	50,000.00
May 6, 1983	50,000.00
August 8, 1983	50,000.00
August 8, 1983	50,000.00
November 28, 1983	40,000.00
November 28, 1983	50,000.00
	$944,269.22

[1]Amounts paid by remittances to petitioner. The remaining payments were made by telegraphic transfer directly into the Osaka account.

There is no evidence that any amounts other than the proceeds from the Gosen payments were deposited into the Osaka account.

Once the amounts were deposited into the Osaka account, petitioner withdrew them for various reasons. Petitioner withdrew a large amount from the Osaka account to transfer to his personal accounts maintained in the United States. To effect these transfers, petitioner withdrew money in

small increments and then mailed them to the United States. Petitioner utilized this method of transferring funds to avoid violating customs laws. Petitioner also withdrew funds to pay for his traveling expenses while in Japan. Petitioner testified at trial that he took no deductions for expenses incurred while traveling in Japan. Lastly, petitioner transferred a large amount, $100,000, to a Singapore account set up by him in 1984. From 1980 through 1983, petitioner withdrew $565,551 from the Osaka account in the following yearly amounts: $66,370 in 1980, $215,287 in 1981, $140,571 in 1982, and $143,323 in 1983.

At petitioner's request, the Bank of America in Osaka held all bank statements for the Osaka account at the Osaka Bank. Petitioner never received any of these bank statements. During the years in issue, neither Mrs. Alexander, EAI's office

manager, or petitioner's accountant was aware of this account.

In each of the years in issue, Gosen prepared statements approximately once every 3 months for EAI outlining the amount and source of each of the Gosen payments. Gosen never mailed these statements to the corporation but rather held them for petitioner to review and sign when he visited Japan. Petitioner kept no records of the Gosen payments. During or prior to the years in issue, petitioner never informed his corporate staff about the Gosen payments.

Neither the Alexanders nor EAI reported the Gosen payments as income on their tax returns in the years in issue. Petitioner testified at trial that he did not report the income in the years in issue because he purportedly was advised by Mr. K. Bartelt, Mr. E. Bartelt's father, that the income was not taxable until brought into the United

States. On brief, petitioner contends he did not report the income in the years in issue because there was a certain restriction on the funds.

This alleged "restriction" involved an NTA audit of Gosen conducted to determine whether Gosen properly deducted the Gosen payments. At the time the parties entered the Gosen agreements, Gosen was unsure whether the NTA would approve its deductions for these payments; therefore, petitioner and Gosen orally agreed that if the NTA determined that Gosen improperly deducted the Gosen payments, the payments would be returned to Gosen. No one but petitioner and Gosen knew of this oral agreement until after the IRS began its audit in July 1984. Petitioner never received any written documentation from the NTA regarding the nature of its audit.

Petitioner also never received any written documentation from the NTA informing

him he could not withdraw funds from the Osaka account. Petitioner testified that the only restriction on the Gosen payments was his contingent obligation to return the payments. After February 28, 1984, petitioner learned the NTA had completed its audit of Gosen and had allowed Gosen's deductions for the payments.

In May 1984, the NTA notified the IRS of the potential existence of petitioner's Osaka account, the Gosen agreements and the Gosen payments. On July 23, 1984, the IRS contacted petitioner for the first time. At this point, petitioner told his accountant, Mr. E. Bartelt, another accountant, and his corporate attorney about the Osaka account, the Gosen agreements, the Gosen payments, and his contingent oral agreement to return the payments. Sometime in late 1984, these three tax advisers determined the Gosen payments had not accrued as income until the NTA had finished its audit in 1984 and,

thus, petitioners should not include the Gosen payments in their income until their 1984 taxable year. In October 1984, petitioners' attorney suggested that a statement be attached to the corporation's tax return for the taxable year 1983 outlining the scope of the NTA audit. Following this advice, EAI attached the following statement to its return for taxable year 1983:

> Taxpayer has been advised that the Japanese Tax Authorities have recently completed an examination of taxpayer's Japanese supplier. Taxpayer understands that the Japanese Tax Authorities have authorized the propriety of payments to the taxpayer of amounts originally held in an account maintained in Japan. Report of the examination was not provided taxpayer until

after its fiscal year ended February 1984 and the supplier notified it of the release of any claim for the earlier fiscal year involved. Accordingly, these amounts will be included in taxpayer's income for the later year subject to conclusion of the pending Internal Revenue Service investigation into prior fiscal year of taxpayer.

While it is expected that these amounts will total $870,000.00, a cursory review of the records require a deposit search to determine whether any payment was previously recognized by the taxpayer.

Following the tax advisers' advice, Shokai, as successor of EAI, reported the income on its subchapter S corporate income tax return for the taxable year 1984. The

Alexanders reported the income on their 1984 joint individual income tax return. There is no indication that petitioner was advised prior to or during the years in issue that the income was not taxable until the NTA had completed its audit.

Reliance on Mr. K. Bartelt

Mr. K. Bartelt was an accountant and petitioner's friend. Mr. K. Bartelt retired as an accountant in 1968 and left his business to his son, Mr. E. Bartelt. Prior to his retirement, Mr. K. Bartelt advised petitioner on tax matters; after his retirement, he continued to advise petitioner on an informal basis. In the late seventies, petitioner asked Mr. K. Bartelt about the U.S. tax treatment of the Gosen payments. He was advised that the Gosen payments were not taxable until they were actually brought into the United States. Subsequently, petitioner brought a portion of the Gosen payments into the

United States; he did not report them in taxable income at this time. During the years in issue, Mr. K. Bartelt was aware of the Osaka account, but was not aware of petitioner's contingent oral agreement to return the Gosen payments.

Reliance on Mr. E. Bartelt

Mr. E. Bartelt, a certified public accountant, served as an officer of EAI for the taxable years 1980 through 1983. However, Mr. E. Bartelt performed no official corporate duties. for the years in issue, Mr. E. Bartelt prepared EAI's and Shokai's corporate income tax returns. He also prepared the Alexanders' Federal individual income tax returns and personal financial statements for the years in issue. Prior to the 1984 IRS audit, Mr. E. Bartelt was not aware of the existence of the Gosen agreements, the Gosen payments, the Osaka account, or petitioner's contingent oral agreement to return the Gosen payments.

Petitioner never requested Mr. E. Bartelt's advice prior to 1984 about the tax treatment of the Gosen payments. Petitioner informed Mr. E. Bartelt of the Gosen payments, etc., after petitioner was contacted in July 1984 by a special agent from the IRS.

Notices of Deficiency

In his notice of deficiency to Shokai, as successor of EAI, respondent made the following determinations: (1) The corporation received unreported income from Gosen in the amounts of $231,983, $175,000, $247,286, and $290,000 in the taxable years 1980 through 1983, respectively; (2) the $36,000 the corporation paid to Mrs. Alexander annually in the taxable years 1980 through 1982 was improperly deducted as a salary expense because such amounts were unreasonable, excessive, or paid for personal services not actually rendered; (3) the amounts the corporation expended on automobile insurance for the corporate-owned

Mercedes used by Mrs. Alexander in the amounts of $949, $1,122, $1,098, and $1,380 for the taxable years 1980 through 1983, respectively, were improperly deducted because Mrs. Alexander provided no discernible services to the corporation; (4) the depreciation on the corporate-owned Mercedes used by Mrs. Alexander in the amounts of $7,583, $7,945, $5,675 and $4,053 for the taxable years 1980 through 1983, respectively, was improperly deducted because the car was not used in a trade or business or for the production of income; (4) the amounts the corporation expended on vehicle license fees for the corporate-owned Mercedes used by Mrs. Alexander in the amounts of $427 in 1981 and $350 in 1982 were improperly deducted because Mrs. Alexander provided no discernible services to the corporation; (5) the $3,539 claimed as an investment tax credit in 1980 on the purchase of the Mercedes used by Mrs.

Alexander was improper because the corporation did not establish the Mercedes was acquired and placed into service as qualifying property used in a trade or business; and (6) the corporation was liable for the additions to tax as enunciated in the opening statement of this opinion.

Respondent issued separate notices of deficiency to petitioner and Mrs. Alexander. The notices of deficiency were issued separately to exclude Mrs. Alexander from any implication of fraud. In the notice of deficiency to petitioner, respondent made the following determinations: (1) Petitioner received unreported income from Gosen in the amounts of $184,637, $333,346, $247,286, and $242,776 in the taxable years 1980 through 1983, respectively; (2) petitioner failed to report a long-term capital gain of $15,359 (after an applicable section 1202 capital gains deduction) from a return of capital from EAI in the taxable

year 1983; (3) petitioner improperly characterized the dividend income received from EAI as salary income in the amounts of $20,000, $26,000, and $62,000 in the taxable years 1980 through 1982, respectively; (3) petitioner failed to report the value of Mrs. Alexander's use of the corporate-owned Mercedes as income in the amounts of $4,200, $7,200, $7,200, and $6,028 in the taxable years 1980 through 1983, respectively; and (5) petitioner was liable for the additions to tax as enunciated in the opening statement of this opinion.

In his separate notice of deficiency issued to Mrs. Alexander, respondent made the following determinations: (1) Mrs. Alexander received unreported income from Gosen in the amounts of $247,286 and $242,776 in the taxable years 1982 and 1983, respectively; (2) Mrs. Alexander failed to report a long-term capital gain of $15,359 (after an applicable section 1202 capital

gains deduction) from a return of capital from EAI in the taxable year 1983; (3) Mrs. Alexander improperly characterized the dividend income received from EAI in 1982 as salary income in the amount of $62,000; (4) Mrs. Alexander failed to report the value of her use of the corporate-owned Mercedes as income in the amounts of $7,200 and $6,208 in the taxable years 1982 and 1983, respectively; and (5) Mrs. Alexander was liable for the additions to tax as enunciated in the opening statement of this opinion.

OPINION

I. SALARY PAYMENT TO MRS. ALEXANDER

A. Propriety of the Deduction by the Corporation

During all the years in issue, Mrs. Alexander held the official position at EAI of corporate secretary. In each of its taxable years 1980, 1981, and 1982, EAI paid Mrs. Alexander $36,000 and deducted this

amount as "Officer's Salary". In his notice of deficiency to the corporation, respondent determined EAI improperly deducted these amounts because they were unreasonable, excessive, or paid for personal services not actually rendered.

Section 162(a) allows as a deduction a reasonable allowance for salaries or other compensation for personal services rendered when such allowances are ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Any amount paid in the form of compensation, but not in fact paid as the purchase price of services, is not deductible. Sec. 1.162-7(b)(1), Income Tax Regs.

In the instant case, when petitioner began his importing business, he operated it out of his home with the assistance of his wife. Mrs. Alexander's duties consisted of lending the corporation money, answering

telephones, typing letters and invoices, talking to customs brokers, signing checks and the corporate minutes, and advising petitioner on the quality of imported tennis apparel.

Petitioner moved the business out of his home in the late seventies. At this time, he hired Mr. Ritzman to replace Mrs. Alexander. Mr. Ritzman was subsequently replaced in March 1983 by Mr. Ziegler. After Mr. Ritzman replaced Mrs. Alexander, petitioners never enunciated clearly what, if any, services she continued to render to the corporation. When petitioner traveled overseas three or four times a year, Mrs. Alexander may have taken and forwarded messages to him. However, petitioners failed to establish this fact clearly. It is clear she never came into the office and was no longer actively involved in the affairs of the corporation. While she still held the official position of corporate

secretary, the record does not indicate she performed any official duties. Petitioners have the burden of proving that the amounts it expended represented the purchase price of services performed by Mrs. Alexander during these taxable years. Rule 142(a). Petitioners have not met this burden of proof.

Mr. E. Bartelt, the accountant who determined the amount of Mrs. Alexander's compensation, claimed some of these annual payments represented compensation for past services rendered by Mrs. Alexander. However, petitioners presented no evidence proving such an assertion. Thus, they again failed to satisfy their burden of proof.

Therefore, we hold that the $36,000 EAI paid Mrs. Alexander in taxable years 1980 through 1982 was not a reasonable allowance for salary or other compensation for personal services Mrs. Alexander rendered during or prior to these taxable years.

Accordingly, we sustain respondent's determination disallowing EAI's $36,000 annual salary deduction in the taxable years 1980, 1981, and 1982.

B. Tax Treatment of the Payment to Mrs. Alexander

On their joint tax returns for 1980, 1981, and 1982, the Alexanders reported $46,000, $26,000, and $62,000, respectively, as salary income earned by Mrs. Alexander from EAI. Respondent recharacterized $20,000, $26,000, and $62,000 of these amounts as dividend income for the taxable years 1980, 1981, and 1982, respectively. Because Mrs. Alexander owned no stock in EAI, respondent determined the payments were properly characterized as constructive dividends to petitioner, EAI's sole stockholder.

A payee's tax treatment of amounts ostensibly paid to him as compensation, but not allowed to be deducted as such by the

payor, will depend upon the circumstances of each case. Sec. 1.162-8 Income Tax Regs. If such payments do not represent amounts paid as compensation for services rendered, they must be treated as what they actually are. Sterno Sales Corp. v. United States, 170 Ct. Cl. 506, 345 F. 2d 552, 556 (1965).

Petitioners argue that the payments to Mrs. Alexander were made to compensate her for services rendered. However, as discussed supra, petitioners have failed to prove Mrs. Alexander actually rendered any services to the corporation during or prior to the years in issue that would justify characterizing the payments as such.

In our view, respondent correctly determined that the alleged "salary" payments made by EAI to Mrs. Alexander were in substance constructive dividends paid to petitioner. Despite an intrafamily gratuitous assignment of income, income remains taxable to a taxpayer when he earns

it or derives it from property he owns. Helvering v. Eubank, 311 U.S. 122 (1940); Helvering v. Horst, 311 U.S. 112 (1940); Lucas v. Earl, 281 U.S. 111 (1930). In the instant case, the only inference to be drawn from the evidence is that the alleged "salary" payments were made by EAI because of petitioner's controlling stock ownership and, therefore, were in substance a return on the stock owned by petitioner.

When EAI made the payments to Mrs. Alexander, petitioner owned all the stock in EAI. Because of Mrs. Alexander's relationship to petitioner, the payments bore a close relationship to the corporation's entire stockholdings. The payments also were in the nature of a distribution of corporate earnings because during the years in issue EAI distributed none of its earnings as dividends, yet Mrs. Alexander annually received a portion of them as salary payments. Further, petitioners

presented no proof disputing respondent's determination.

We find that the payments were in substance a return on the stock owned by petitioner and are properly characterized as constructive dividends to petitioner in the amounts determined by respondent. See Broad v. Commissioner, T.C. Memo. 1990-317 (alleged "salary" payments to children of controlling stockholders found to be constructive dividends to stockholders where taxpayers failed to prove children rendered any services to the corporation); Jolly's Motor Livery Co. v. Commissioner, T.C. Memo. 1957-231 (alleged "salary" payments to wife of controlling stockholder found to be constructive dividends to stockholder where wife performed no services for corporation).

II. MRS. ALEXANDER'S AUTOMOBILE EXPENSES

During each of its taxable years 1980 through 1983, EAI provided Mrs. Alexander with a corporate-owned Mercedes Benz. The

corporation purchased the Mercedes in 1980 for $35,389 and claimed an investment tax credit of $3,539 in this taxable year. In 1980 through 1983, the corporation paid for the automobile insurance and license fees on this vehicle and claimed deductions for depreciation, automobile insurance, and license fees. The Alexanders did not report the value of Mrs. Alexander's use of the automobile as income on any of their joint tax returns.

Respondent determined that the corporation improperly deducted the expenses it incurred pertaining to the Mercedes because Mrs. Alexander provided no discernible services to the corporation. Respondent also determined EAI improperly claimed the investment tax credit because the corporation failed to establish the Mercedes was acquired and placed into service as qualified property used in a trade or business. Respondent also

determined that the Alexanders failed to report the value of Mrs. Alexander's personal use of the Mercedes as income in the taxable years 1980 through 1983 in the amounts of $4,200, $7,200, $7,200, and $6,028, respectively.

Regarding the propriety of the deductions taken by the corporation, it is well established that when corporate property is used by a shareholder or member of his family for personal purposes, not proximately related to the corporate business, the corporation is not entitled to deductions to the extent that the corporate property was used for personal reasons. Falsetti v. Commissioner, 85 T.C. 332, 356 (1985). Petitioners presented no evidence indicating Mrs. Alexander used the automobile for any corporate business purpose. The parties stipulated that petitioner occasionally used the car, but petitioners presented no evidence indicating

his use was for business purposes. Petitioners presented no other evidence indicating the Mercedes was used for business purposes during the taxable years 1980 through 1983. We conclude, therefore, that the corporation improperly deducted expenses for depreciation, license fees, and insurance, and improperly claimed an investment tax credit pertaining to the Mercedes in the amounts determined by respondent.

Regarding the Alexanders' tax treatment of Mrs. Alexander's use of the automobile, it is also well established that when corporate property is used by a shareholder or member of his family for personal purposes, not proximately related to the corporate business, the value of such property is includable in the shareholder's income as a constructive dividend. Falsetti v. Commissioner, supra at 356. According to the Court of Appeals for the Ninth Circuit,

to which an appeal of this case would lie, for the value of the personal use of corporate property to be treated as a constructive dividend for tax purposes, the expenses (1) must be nondeductible to the corporation, and (2) must represent some economic gain or benefit to the shareholder. Palo Alto Town & Country Village, Inc. v. Commissioner, 565 F. 2d 1388, 1391 (9th Cir. 1977), affg. in part, revg. in part, and remanding T.C. Memo. 1973-223.

In the instant case, these expenses were nondeductible to the corporation. Furthermore, Mrs. Alexander economically benefited from her use of the corporate-owned Mercedes because she personally used the Mercedes without paying any part of its purchase price and without incurring any expenses for insurance or license fees. Petitioners have presented no evidence disputing respondent's determination of the value of Mrs.

Alexander's personal use of the Mercedes. We conclude that the value of Mrs. Alexander's personal use of the Mercedes is to be taxed as constructive dividend income to petitioner in the amounts determined by respondent.

III. TAX TREATMENT OF INCOME FROM THE GOSEN PAYMENTS

A. Whose Income the Gosen Payments Are

Between March 4, 1980, and November 28, 1983, Gosen paid petitioner $944,269.22 pursuant to the Gosen agreements. This sum represented payments received for commissions and currency fluctuations. Respondent alleges that these proceeds were gross receipts of EAI diverted by petitioner.

When controlling shareholders divert corporate receipts to themselves, the diverted receipts are fully taxable to the corporation to which they are attributable. Truesdell v. Commissioner, 89 T.C. 1280,

1300 (1987). Further, these funds are properly treated as constructive dividends to the controlling shareholders for tax purposes. United States v. Miller, 545 F. 2d 1204, 1211 (9th Cir. 1976); DiLeo v. Commissioner, 96 T.C. 858, 883 (1991).

Accordingly in the instant case, respondent determined that the proper tax treatment of the diverted funds was that EAI received unreported income in the taxable years 1980 through 1983 in the amounts of $231,983, $175,000, $247,286, and $290,000, respectively. Respondent also determined the diverted corporate funds were to be included in the Alexanders' taxable income. To the extent EAI had sufficient earnings and profits, respondent included the diverted funds in gross income as dividends. Secs. 316(a), 301(c)(1). To the extent the amount of the diverted funds exceeded both EAI's earnings and profits and petitioner's adjusted basis in the stock, respondent

treated the funds as a gain from the sale or exchange of property. Sec. 301(c)(2) and (3). Respondent determined the Alexanders had dividend income of $184,637, $222,346, $247,286, and $242,776 in the taxable years 1980 through 1983, respectively, and a gain from the sale or exchange of property of $15,359 (after an applicable section 1202 capital gains deduction) in taxable year 1983.

Petitioners argue that the proceeds from the Gosen payments were never receipts of the corporation but instead were only receipts of petitioner; therefore, petitioner never diverted corporate receipts. The crux of petitioners' argument is that petitioner was not acting in his official capacity as president of the corporation when he executed the Gosen agreements or when he received the Gosen payments. Petitioners argue that both Gosen and petitioner believed the Gosen agreements

were personal agreements between Gosen and petitioner and not between Gosen and EAI. The facts indicate otherwise, however.

A corporation cannot act for itself; it can act only through its officers and agents. American Lithofold Corp. v. Commissioner, 55 T.C. 904, 925 (1971). In the instant case, each of the Gosen agreements refers to the parties as Gosen and EAI. The Gosen agreements pertained solely to purchases by EAI as Gosen's exclusive U.S. sales agent. Thus, the agreements were not ventures entered into separately from EAI's corporate business. Additionally, the Gosen payments were based solely on EAI's purchases and were not made to compensate petitioner for any additional services rendered by him. Further, petitioner signed two of these agreements specifically as president of EAI. All of these facts indicate petitioner was in fact acting in his official capacity for the corporation

when he executed the Gosen agreements and when he received the Gosen payments.

Petitioners argue on brief that Gosen and petitioner believed the Gosen agreements were personal agreements between themselves. However, both Mr. Matsuo, who was head of the export-import department of Gosen and who was involved in the execution of all the Gosen agreements, and petitioner testified that all the Gosen agreements were between Gosen and EAI. They both further testified that the commission payments were based on the amount of sales by Gosen to EAI. EAI even acknowledged the Gosen payments as its income on the statement attached to its 1983 corporate income tax return. Finally, Shokai, as successor of EAI, reported the income on its 1984 corporate income tax return. Thus, in actuality, the parties believed the Gosen agreements were agreements between Gosen and EAI and not between Gosen and petitioner.

We have reviewed the cases cited by petitioners in their brief and in support of their arguments on this issue and find them to be nondispositive. We have also considered petitioners' other arguments in their brief and find them unpersuasive or without merit.

In sum, based on the fact that petitioner was acting in his official capacity for the corporation when he executed the Gosen agreements and when he received the Gosen payments, and based on the understanding of both the pertinent parties that the Gosen agreements were between the corporations, we conclude that the Gosen payments were gross receipts of EAI.

Even though the proceeds from the Gosen payments were gross receipts of EAI, none of them were recorded on the corporate books as income or deposited into the corporation's bank account. Instead, petitioner treated

these receipts as his income during the years in issue. Two of the Gosen payments were made by direct remittances to petitioner, and the remaining were electronically deposited into his Osaka account. While the NTA requested the payments be made by bank transfer, petitioner specifically requested they be deposited into his Osaka account. There is no indication any other funds were deposited into the Osaka account in any of the years in issue.

Petitioner withdrew funds from his Osaka account for various reasons. Petitioner withdrew a large amount to transfer to his personal accounts maintained in the United States. To effect these transfers, petitioner withdrew money in small increments and then mailed them to the United States. Petitioner utilized this method of transferring funds to avoid violating customs laws. Petitioner also

withdrew funds from the Osaka account to pay for his expenses incurred while traveling in Japan and to transfer to his Singapore account. In the taxable years 1980 through 1983, petitioner withdrew $565,551 from this account in the following yearly amounts: $66,370 in 1980, $215,287 in 1981, $140,571 in 1982, and $143,323 in 1983. Petitioner could and did use the proceeds from the Gosen payments as he desired and, thus, treated these proceeds as his own income during the years in issue.

In sum, petitioner diverted the Gosen payments, the corporate receipts of EAI, to himself during the taxable years 1980 through 1983. Accordingly, such receipts are fully taxable to EAI, the corporation to which they are attributable, and properly treated as constructive dividends to the Alexanders for tax purposes as determined by respondent.

B. <u>When the Gosen Payments are Includable</u>

in Taxable Income

Respondent alleges the income from the Gosen payments was reportable in the taxable income of EAI and the Alexanders in the years that petitioner received them in his Osaka account.

Petitioners, all cash basis taxpayers, argue that this income was not reportable upon receipt because the income had a "restriction" on its disposition. This restriction involved the oral agreement that the proceeds be returned if the NTA determined Gosen improperly deducted the Gosen payments. Petitioners allege they properly reported the income in their 1984 taxable year when the NTA completed its audit and allowed Gosen's deductions for the Gosen payments.

Generally, for cash basis taxpayers, all items which constitute income are to be reported as income in the taxable year received. Sec. 1.451-1(a), Income Tax Regs.

However, if a cash basis taxpayer receives income that he may have to return, the income may or may not be reportable in taxable income upon receipt. If such income is not subject to any restrictions on its disposition and the taxpayer receives the income pursuant to a "claim of right", the income is includable upon receipt. North American Oil Consolidated v. Burnet, 286 U.S. 417, 424 (1932).

For earnings to be included in taxable income upon receipt pursuant to the "claim of right" doctrine, the taxpayer (1) must have received money or other property; (2) must have control over the utilization and disposition of the received money or property; and (3) must assert a "claim of right" or entitlement to receive the money or property. Id. at 424. A taxpayer has a claim of right or entitlement to receive money or property when funds are received and treated by him as belonging to him.

Healy v. Commissioner, 345 U.S. 278, 282 (1953).

The Gosen payments were unequivocally deposited into petitioners' Osaka account. Thus, petitioner received the Gosen payments.

Petitioner also had control over the utilization and disposition of these payments. The payments were either deposited directly into the Osaka account, petitioner's personal bank account, or were paid by remittances to him. There is no indication any other funds were deposited into this account. Of the funds deposited into this account, petitioner freely withdrew them to pay for traveling expenses when he traveled to Japan, to transfer back to the United States to deposit into his personal accounts, or to transfer into his Singapore account. While petitioner had a contingent obligation to return the Gosen payments should the NTA disallow Gosen's

deduction for the payments, the funds were not required to be held in the Osaka account until the NTA or any other entity or person authorized their release. In sum, petitioner could freely utilize and dispose of all the Gosen payments deposited into his Osaka account during the years in issue.

Finally, petitioner had a "claim of right" or entitlement to receive the Gosen payments because, as shown supra, he received and treated the Gosen payments as belonging to him.

Petitioners argue that Mutual Telephone Co. v. United States, 204 F. 2d 160 (9th Cir. 1953), is dispositive of this issue and would require the Gosen payments not be included in taxable income upon receipt. The facts in Mutual Telephone are different from the facts in the instant case, however. In Mutual Telephone, the taxpayers could not withdraw any of its income deposited in an

account until a particular governmental agency approved of the withdrawal. Id. at 160-161. The Ninth Circuit held that in this situation, the taxpayers did not have control over the utilization and disposition of the moneys deposited in the account. Id. at 161-162. In the instant case in contrast, petitioner withdrew the Gosen payments from his Osaka account without the approval of any person or any entity. Therefore, petitioners' reliance on Mutual Telephone is misplaced.

Petitioners also argue that Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990), is dispositive of this issue and would require that the income not be taxable upon receipt. Indianapolis Power, however, has no bearing on the instant issue. The issue present in Indianapolis Power was whether moneys received by a taxpayer were advance payments of income or were deposits. The Court

stated that the proper test for making this determination was whether the taxpayer enjoyed "complete dominion" over the moneys. Id. at 593. The Court further stated that a taxpayer does not have "complete dominion" over a given sum until the taxpayer has some guarantee that he will be allowed to keep the given sum. Id. at 593.

In the instant case, petitioners assert that because they had no guarantee they would be allowed to keep the Gosen payments until the NTA completed its audit in 1984, they did not have "complete dominion" over the payments until this time. Thus, petitioners conclude, the income was not reportable in taxable income until taxable year 1984. Petitioners' reliance on this language is inappropriate, however. The "complete dominion" language in Indianapolis Power is used only to distinguish advance payments from deposits. Whether the Gosen payments were advance payments or deposits

is not the issue in the instant case.

We hold that the Gosen payments are to be included in the taxable income of EAI and the Alexanders in the years received by petitioner as determined by respondent.

IV. PETITIONER'S FRAUD

Respondent determined that the income tax deficiencies for which petitioner is liable for the taxable years 1980 through 1983 resulting from his failure to report the Gosen payments as income were due to a fraudulent intent to evade paying taxes known to be owing. If respondent's determination is correct, (1) the statute of limitations does not bar the assessment and collection of the deficiencies and additions to tax set forth in respondent's notice of deficiency to petitioner for the taxable years 1980 through 1983, and (2) petitioner is liable for the additions to tax for fraud pursuant to section 6653(b) for the taxable years 1980 through 1983. These issues will

be discussed in subsequent sections of this opinion following our discussion regarding petitioner's fraudulent intent.

A. Petitioner's Fraudulent Intent

In any case involving the issue of fraud with the intent to evade paying taxes known to be owing, the burden of proof is on respondent to prove by clear and convincing evidence that the taxpayer intended to evade paying taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of taxes. Sec. 7454(a); Rule 142(b); DiLeo v. Commissioner, 96 T.C. at 874; Truesdell v. Commissioner, 89 T.C. at 1301. The existence of fraud is a question of fact to be resolved from the entire record. DiLeo v. Commissioner, supra at 874; Truesdell v. Commissioner, supra at 1301. The taxpayer's entire course of conduct may establish the requisite fraudulent intent. Rowlee v. Commissioner, 80 T.C. 1111, 1123 (1983).

Fraud is not to be presumed. Truesdell v. Commissioner, supra at 1301. Because fraud can rarely be established by direct proof of a taxpayer's intent, however, respondent may establish the required quantum of proof by circumstantial evidence. DiLeo v. Commissioner, supra at 874; Truesdell v. Commissioner, supra at 1301. The Court of Appeals for the Ninth Circuit reaffirmed that it is appropriate to infer fraudulent intent from various kinds of circumstantial evidence and has set forth a nonexclusive list of the "badges of fraud" that demonstrate fraudulent intent. These badges of fraud include: (1) Understatements of income, (2) the maintenance of inadequate records, (3) the concealment of assets, (4) implausible or inconsistent explanations of behavior, (5) a failure to file tax returns, and (6) a failure to cooperate with tax authorities. Bradford v. Commissioner, 796 F. 2d 303, 307

(9th Cir. 1986), affg. T.C. Memo. 1984-601.

Understatements of Income. Not only is an understatement of income circumstantial evidence of fraud, Bradford v. Commissioner, supra at 307, but as indicated by this Court, a consistent and substantial understatement of income is by itself strong evidence of fraud. Truesdell v. Commissioner, supra at 1302. In the instant case, respondent determined the Alexanders recognized income from the Gosen payments for 1980 through 1983 in the amounts of $184,637, $222,346, $247,286, and $258,135 ($242,776 as dividend income and $15,359 as a gain from the sale or exchange of property), respectively. The Alexanders did not, however, report any of this income in the taxable years in issue. The Alexanders did report gross income for these years in the amounts of $344,601, $219,546, $251,603, and $284,810, respectively. Thus, the Alexanders understated their income in 1980

by 34 percent, in 1981 by 50 percent, in 1982 by 49 percent, and in 1983 by 47 percent. We conclude that the Alexanders substantially understated their income in these years.

Accordingly, these substantial understatements are strong evidence of petitioner's fraudulent intent in the taxable years 1980 through 1983. This fact together with the following facts evidencing petitioner's intent to conceal the existence and receipt of the Gosen payments actually justifies the inference of fraud. See Brooks v. Commissioner, 82 T.C. 413, 431 (1984).

The Maintenance of Inadequate Records. Petitioner kept no records of the amounts earned or received from Gosen for the Gosen payments. He did not even receive the bank statements for the Osaka account during the years in issue. While Gosen prepared statements for EAI outlining the amount of

the Gosen payments, it did not send these statements to EAI or petitioner. Instead, Gosen held the statements for petitioner to review and to sign when he visited Japan. There is no indication petitioner kept any copies of these statements. In sum, petitioner not only maintained inadequate records on the Gosen payments but maintained no records. His failure to maintain any records signifies his intent to conceal the existence and receipt of the Gosen payments.

The Concealment of Assets. Further evidence of petitioner's intent to conceal the existence of the Gosen payments is that only a few people knew of the existence of the payments or the Osaka account. There is no evidence that any person or entity, other than petitioner, Gosen, and Mr. K. Bartelt, knew of the existence of either prior to 1984. Prior to 1984, Mr. E. Bartelt, the accountant who prepared EAI's and the Alexanders' tax returns, did not know of

either.

EAI's office manager also did not know of the Gosen payments or the Osaka account. EAI's office manager made deposits into the corporation's bank account, invoiced customers, paid corporate expenses, signed corporate checks, forwarded income and expense information to Mr. E. Bartelt, the corporate accountant, for entry into the corporate books, answered the telephone, and opened mail. This person was actively involved in the corporation's financial affairs. In the normal course of performing his duties, he should have discovered the existence of the Gosen payments and the Osaka account. His failure to do so further indicates petitioner's efforts to conceal the existence of the Gosen payments and the Osaka account.

Other miscellaneous evidence signifies petitioner's intent to conceal the existence of the Gosen payments and the Osaka account.

Petitioner specifically requested the Gosen payments be sent to his Osaka account in Japan to the exclusion of any bank account he or EAI maintained in the United States. Petitioner also requested all bank statements be held in Japan and not be mailed to him in the United States. These facts further illustrate petitioner's efforts to conceal the existence of the Gosen payments and the Osaka account.

Implausible or Inconsistent Explanations of Behavior. Petitioner's implausible and inconsistent explanations for some of his behavior also signify his fraudulent intent. Petitioner explained at trial that he did not report the Gosen payments as income because Mr. K. Bartelt advised him the income was not taxable until brought into the United States. However, this proffered explanation is implausible since petitioner did not report the income

even when he did bring it into the United States.

Further, petitioner argued on brief that he did not report the Gosen payments because he felt the alleged restriction involving the potential return of the payments precluded him from having to do so. This reason is inconsistent with the reason stated at trial for why he failed to report the income. It is also an implausible explanation of why he did not report the income since there is no indication he was advised prior to or during the years in issue that the payments were not taxable until the "restriction" was removed.

We also find petitioner's testimony that he was ignorant "as far as tax business" to be unbelievable. While petitioner had only a high school level education, never received any formal training in accounting, bookkeeping, or the preparation of tax returns, and claims never

to have prepared or reviewed any tax returns, many objective facts exist indicating petitioner's familiarity with tax concepts and participation in tax planning.

Petitioner had discussed with his accountant setting up a domestic international sales corporation to alleviate the tax burden of foreign earned income. They also discussed the tax advantages of purchasing municipal bonds. As mentioned several time supra, he also inquired of and discussed with Mr. K. Bartelt the proper tax treatment of the Gosen payments. Petitioner also discussed with his corporate attorney such tax topics as controlled foreign corporations, the attribution rules of subchapter F, and the availability of lower tax rates in lesser-developed countries.

We also find implausible petitioner's claim that he never reviewed tax returns or took any part in classifying deductions for

income tax purposes. At trial, petitioner testified he took no deductions for traveling expenses incurred while traveling in Japan. If he never reviewed a tax return and never participated in classifying deductions, it is not easy to believe that he knew what deductions were actually taken. By denying that he claimed any deductions for travel, petitioner contradicts his claim never to have reviewed a tax return or participated in classifying deductions.

We conclude that in the taxable years 1980 through 1983, petitioner substantially understated his taxable income, maintained inadequate records of the Gosen payments, concealed the existence of both the Gosen payments and the Osaka account, and provided implausible and inconsistent explanations for some of his behavior. Accordingly, we are convinced petitioner intended to evade paying taxes known to be owing for the taxable years 1980 through 1983 by conduct

intended to conceal, mislead or otherwise prevent the collection of taxes due from the Gosen payments.

Moreover and in accordance with the Fifth Circuit's decision in United States v. Thetford, 676 F. 2d 170 (5th Cir. 1982), we are further convinced petitioner committed fraud in 1980 through 1983. In Thetford, the Fifth Circuit held that a taxpayer's diversion of corporate funds to his own use, coupled with his failure to report such funds as income or to make any adjustment in the corporate books to reflect a return of capital, is sufficient to imply a willful intent to evade paying taxes. Id. at 175. Similarly, in the instant case, petitioner also had control of diverted corporate funds yet failed to report them as taxable income or to make any adjustment in the corporate books to reflect a return of capital.

We hold respondent has presented sufficient circumstantial evidence proving

by clear and convincing evidence that petitioner intended to evade paying taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of taxes due in the taxable years 1980, 1981, 1982, and 1983.

B. Petitioner's Reliance on an Accountant

A taxpayer may rebut the Government's proof of fraud by establishing a good faith reliance on a qualified accountant after full disclosure of tax-related information. United States v. Claiborne, 765 F. 2d 784, 798 (9th Cir. 1985); Estate of Temple v. Commissioner, 67 T.C. 143, 162 (1976). Petitioner argues he reasonably relied on the advice of either Mr. K. Bartelt or Mr. E. Bartelt, both accountants, regarding the tax treatment of the Gosen payments and therefore can rebut respondent's proof of fraud. We conclude, however, petitioner did not rely on any advice offered by either of the Bartelts.

Mr. K. Bartelt was an accountant and petitioner's friend. Mr. K. Bartelt retired as an accountant in 1968 and left his business to his son, Mr. E. Bartelt. Prior to his retirement, Mr. K. Bartelt advised petitioner on tax matters; after his retirement, he continued to advise petitioner on an informal basis. Mr. K. Bartelt specifically advised petitioner the Gosen payments were not subject to U.S. tax until they were actually brought into this country. However, petitioner brought a portion of these moneys into the United States during the years in issue yet did not report them in taxable income. Petitioner, then, did not actually rely on Mr. K. Bartelt's advice. Since Mr. K. Bartelt was not aware of petitioner's contingent oral agreement to return the Gosen payments, he could not have rendered any advice on this issue on which petitioner could have relied. We conclude petitioner did not actually rely

on any advice Mr. K. Bartelt offered.

We conclude also that petitioner did not actually rely on the advice of Mr. E. Bartelt as a reason for not reporting the Gosen payments in taxable income. Mr. E. Bartelt prepared the Alexanders' and EAI's tax returns for the years at issue. He also prepared the Alexanders' personal financial statements. During the years in issue, Mr. E. Bartelt was never aware of the Osaka account, the Gosen agreements, the Gosen payments, or petitioner's contingent oral agreement to return the Gosen payments. Therefore, Mr. E. Bartelt could not have advised petitioner on the tax treatment of the Gosen payments. In fact, petitioner stated at trial he never specifically requested Mr. E. Bartelt's advice on the tax treatment of the Gosen payments.

We have considered petitioners' other arguments on this issue and find them either unpersuasive or without merit.

V. THE CORPORATION'S FRAUD

Respondent also determined the income tax deficiencies for which the corporation is liable resulting from its failure to report the Gosen payments as income for the taxable years 1980 through 1983 were due to a fraudulent intent to evade paying taxes known to be owing. If respondent's determination is correct, (1) the statute of limitations does not bar the assessment and collection of the deficiencies and additions to tax set forth in respondent's notice of deficiency to the corporation for the taxable years 1980 through 1983, and (2) the corporation is liable for the additions to tax for fraud pursuant to section 6653 for the taxable years 1980 through 1983. These issues will be discussed in subsequent sections of this opinion following our discussion regarding the corporation's fraudulent intent.

A. The Corporation's Fraud--Taxable Years 1980, 1981, and 1982

A corporation can act only through its officers and agents, and their intentions must be imputed to the corporation. Botwinik Brothers of Mass., Inc. v. Commissioner, 39 T.C. 988, 996 (1963). When a dominant stockholder/officer's interests are not antagonistic to the corporation, the fraudulent intent of the stockholder/officer has been imputed to the corporation. Auerbach Shoe Co. v. Commissioner, 216 F. 2d 693 (1st Cir. 1954), affg. 21 T.C. 191 (1953); American Lithofold Corp. v. Commissioner, 55 T.C. at 925-926; Ace Tool & Eng., Inc. v. Commissioner, 22 T.C. 833 (1954); see Botwinik Brothers of Mass., Inc. v. Commissioner, supra at 996. In the case of sole or dominant shareholders who divert corporate funds for their own benefit, such shareholders' actions are not regarded as antagonistic to

the corporation since to a large extent these shareholders are merely taking their own money and thus obtaining from the corporation what would otherwise be available to them as dividends. American Lithofold Corp. v. Commissioner, supra at 926; Botwinik Brothers of Mass., Inc. v. Commissioner, supra at 996.

In the instant case, EAI cannot act on its own; its fraud necessarily depends upon the fraudulent acts of its officers and agents. During the years in issue, the record indicates EAI had one stockholder of record--petitioner, and three officers--Mr. E. Bartelt, Mrs. Alexander, and petitioner. As officers, Mr. E. Bartelt and Mrs. Alexander performed no official corporate duties and thus cannot be said to have acted for the corporation in any manner. Petitioner, EAI's president, was then the only officer that performed any official corporate duties for EAI. As president,

petitioner clearly dominated EAI's affairs and controlled all of its business operations.

In sum, petitioner was not only EAI's sole stockholder of record but was also its dominant stockholder/officer during the years in issue. As such, in fraudulently diverting corporate funds to his own use, petitioner's actions are not regarded as antagonistic to EAI. Accordingly, petitioner's fraudulent intent is imputed to EAI for the taxable years 1980 through 1982. Therefore, we sustain respondent's determination that EAI fraudulently intended to evade paying taxes known to be owing in taxable years 1980, 1981, and 1982.

B. The Corporation's Reliance on an Accountant's Advice

The corporation argues it reasonably relied on the advice of either Mr. K. Bartelt or Mr. E. Bartelt in the taxable years 1980, 1981, and 1982 regarding the tax

treatment of the Gosen payments and therefore can rebut respondent's proof of fraud for these years. United States v. Claiborne, supra, at 798; Estate of Temple v. Commissioner, supra at 162. Again, a corporation can act only through its officers and agents. Botwinik Brothers of Mass., Inc. v. Commissioner, supra, at 996. Because we have already held petitioner did not rely on the advice of either Mr. K. Bartelt or Mr. E. Bartelt regarding the tax treatment of the Gosen payments, his lack of reliance is imputed to EAI for taxable years 1980, 1981, and 1982.

C. The Corporation's Fraud--Taxable Year 1983

Respondent also determined the corporation fraudulently intended to evade paying taxes known to be owing in taxable year 1983. The corporation alleges it did not fraudulently intend to evade paying taxes known to be owing in taxable year 1983

because it, inter alia, reasonably relied on the advice of its tax advisers in not reporting the income in this year.

Sometime after February 28, 1984, petitioner learned the NTA had completed its audit of Gosen. In May of the same year, the NTA notified the IRS of the potential existence of petitioner's Osaka account, the Gosen agreements, and the Gosen payments. In July, the IRS contacted petitioner for the first time regarding the tax liabilities in issue. At this point, petitioner for the first time disclosed the existence of the Gosen agreements, the Gosen payments, the Osaka account, and the oral agreement regarding repayment to parties besides himself, Mr. K. Bartelt, and Gosen. Petitioner told Mr. E. Bartelt, another a accountant, and his corporate attorney.

These three "tax advisers" determined the Gosen payments had not accrued as income until 1984 when the NTA had finished its

audit of Gosen. Accordingly, they advised the corporation not to report the income until taxable year 1984. They further advised the corporation to attach a statement to its 1983 tax return stating the following:

> Taxpayer has been advised that the Japanese Tax Authorities have recently completed an examination of taxpayer's Japanese supplier. Taxpayer understands that the Japanese Tax Authorities have authorized the propriety of payments to the taxpayer of amounts originally held in an account maintained in Japan. Report of the examination was not provided taxpayer until after its fiscal year ended February 1984 and the supplier notified it of the release of any claim for the earlier fiscal year

involved. Accordingly, these amounts will be included in taxpayer's income for the later year subject to conclusion of the pending Internal Revenue Service investigation into prior fiscal year of taxpayer.

While it is expected that these amounts will total $870,000.00, a cursory review of the records require a deposit search to determine whether any payment was previously recognized by the taxpayer.

The corporation followed the advice of its tax advisers, for it attached the above statement to its 1983 tax return and it did not report the income until taxable year 1984. While we consider this advice to have been erroneous, the corporation, in following it in connection with the return filed for the taxable year 1983, did not

omit income fraudulently with the intent to evade tax. See United Dressed Beef Co. v. Commissioner, 23 T.C. 879, 887 (1955). In conclusion, we do not sustain respondent's determination that EAI fraudulently intended to evade paying taxes known to be owing in taxable year 1983.

VI. STATUTES OF LIMITATIONS

A. The Corporation

The corporation asserts that the statute of limitations bars the assessment and collection of the deficiencies and additions to tax for which it is determined liable for the taxable years 1980 through 1983 because respondent's notice of deficiency was issued after the expiration of the general 3-year limitations period. Respondent counters that the limitations period is extended indefinitely for these years pursuant to section 6501(c)(1) because the corporation filed fraudulent returns for all these years with the intent to evade

paying tax. Additions to tax are assessed and collected in the same manner as taxes. Sec. 6659(a)(1) for 1980 and 1981; sec. 6662(a)(1) for 1982 and 1983.

Regarding taxable years 1980, 1981, and 1982, respondent has established by clear and convincing evidence that EAI fraudulently intended to evade paying taxes known to be owing in these years. Accordingly, the limitations period for issuing the notice of deficiency for taxable years 1980, 1981, and 1982 is extended indefinitely.

However, regarding taxable year 1983, respondent has not established by clear and convincing evidence that EAI fraudulently intended to evade paying taxes known to be owing in this taxable year. Therefore, the statute of limitations is not extended for this taxable year pursuant to section 6501(c)(1) for filing a fraudulent return. Therefore, the statute of limitations does

bar the assessment and collection of the deficiencies and additions to tax of EAI for the taxable year 1983.

B. Petitioner

Petitioner asserts that the statute of limitations bars the assessment and collection of the deficiencies and additions to tax for which he is determined liable for the taxable years 1980 through 1983 because respondent's notice of deficiency was issued after the expiration of the general 3-year limitations period. Respondent counters that this limitations period is extended indefinitely for 1980 and 1981 pursuant to section 6501(c)(1) because petitioner filed fraudulent returns for these years with the intent to evade paying tax. Respondent contends further that the limitations period is extended an additional 6 years for 1982 and 1983 pursuant to section 6501(3)(1)(A) because petitioner failed to report an excess of 25 percent of his gross income in

these years. Again, additions to tax are assessed and collected in the same manner as taxes. Sec. 6659(a)(1) for 1980 and 1981; sec. 6662(a)(1) for 1982 and 1983.

Respondent has established by clear and convincing evidence that petitioner fraudulently intended to evade paying taxes known to be owing for the taxable years 1980, 1981, 1982, and 1983. Therefore, the limitations period for issuing the notice of deficiency determining the deficiencies and additions to tax for these years is extended indefinitely pursuant to section 6501(c)(1). Accordingly, we need not consider whether section 6501(e)(1) applies to extend the general limitations period for 1982 and 1983 because section 6501(c)(1) applies to these years.

C. Mrs. Alexander

Mrs. Alexander also asserts that the statute of limitations bars the assessment and collection of the deficiencies and

additions to tax for which she is determined liable for the taxable years 1982 and 1983 because respondent's notice of deficiency was issued after the expiration of the general 3-year limitations period. However, section 6501(c)(1) extends indefinitely the limitations period for a false or fraudulent joint return where fraud is proven against one spouse. Benjamin v. Commissioner, 66 T.C. 1084, 1100 (1976), affd. 592 F. 2d 1259 (5th Cir. 1979). Accordingly, because respondent has proven petitioner fraudulently failed to report income in taxable years 1982 and 1983 and because the Alexanders filed joint returns for these years, the statute of limitations does not bar the assessment and collection of the deficiencies and additions to tax for which Mrs. Alexander is determined liable for taxable years 1982 and 1983.

VII. THE CORPORATION'S ADDITIONS TO TAX

A. Section 6653(b)/6653(b)(1)--Taxable Years 1980 through 1983

Section 6653(b)(2)--Taxable Years 1982 and 1983

Respondent determined that a portion of the corporation's underpayments for the taxable years 1980 through 1983 was due to fraud. Accordingly, respondent determined the corporation was liable for the 50-percent addition to tax for fraud pursuant to section 6653(b) for the taxable years 1980 and 1981, and pursuant to section 6653(b)(1) for the taxable years 1982 and 1983 on the portion of the understatements attributable to fraud. Respondent also determined the corporation was liable for the addition to tax for taxable years 1982 and 1983, pursuant to section 6653(b)(2), equal to 50 percent of the interest computed on the portion of the underpayment attributable to fraud.

Alternative to the addition to tax for fraud for the taxable years 1982 and 1983, respondent determined the corporation was liable for a 5-percent addition to tax for negligence or intentional disregard of rules and regulations pursuant to section 6653(a)(1), and an addition equal to 50 percent of the interest computed on the portion of the underpayment attributable to negligence or intentional disregard of rules and regulations pursuant to section 6653(a)(2).

For a taxpayer to be liable for the additions to tax for fraud, respondent must prove by clear and convincing evidence that (1) the taxpayer has underpaid his taxes for the year in issue, and (2) some part of the underpayment is due to fraud. Sec. 6653(b) for 1980 and 1981; sec. 6653(b)(1) and 6653(b)(2) for 1982 and 1983; sec. 7454(a); Rule 142(b); DiLeo v. Commissioner, 96 T.C. at 873.

Regarding taxable years 1980, 1981, and 1982, respondent has proven that the corporation underpaid its taxes for the taxable years 1980 through 1982. Respondent has also proven by clear and convincing evidence that the underpayment resulting from the corporation's failure to report the Gosen payments as income as due to fraud. Therefore, we sustain respondent's determination that the corporation is liable for the additions to tax for fraud pursuant to section 6653(b)/6653(b)(1) for the taxable years 1980, 1981, and 1982, and pursuant to section 6653(b)(2) for the taxable year 1982 on the underpayments resulting from the corporation's failure to report the Gosen payments as income. Finally, because we sustain respondent's determination that the corporation is liable for the addition to tax for fraud for the taxable year ended 1982, the corporation cannot also be liable for the addition to

tax for negligence in that year. Sec. 6653(b)(3).

Regarding taxable year 1983, because respondent failed to prove by clear and convincing evidence the corporation fraudulently intended to evade paying taxes known to be owing in this year, we do not sustain respondent's determination that the corporation is liable for the additions to tax for fraud pursuant to section 6653(b)(1) and (2) for 1983. Additionally, because the statute of limitations bars the assessment and collection of the alternative negligence additions pursuant to section 6653(a)(1) and (2) for the taxable year 1983, the corporation is not liable for these additions in that taxable year.

B. Section 6661--Taxable Years 1982 and 1983

Respondent determined that the corporation had a substantial understatement of income tax within the meaning of section

6661 for the taxable years 1982 and 1983. Accordingly, respondent determined the corporation was liable for an addition to tax for these years pursuant to section 6661. As discussed supra at section VI(A), the statute of limitations bars the assessment and collection of this addition for the taxable year 1983. The corporation contests the section 6661 addition for taxable year 1982 on several grounds. We have considered each of these grounds and find all but two to be either unpersuasive and without merit or not adequately proven by the corporation. We will not discuss any of these grounds but two.

The corporation contests the section 6661 addition to tax on the ground that the statute of limitations bars the assessment and collection of this addition for the taxable year 1982. As discussed supra at section VI(A), the statute of limitations does not bar the assessment or collection of

the addition to tax determined against the corporation for the taxable year 1982.

The corporation also contests the section 6661 addition in 1982 on the ground that there was no substantial understatement for this taxable year. Regarding this contention, we have concluded that EAI understated its income in the taxable year 1982 in the amount determined by respondent. Therefore, we sustain respondent's determination on this issue for the taxable year 1982.

C. Section 6651(a)(1)--Taxable Years 1982 and 1983

Respondent determined that the corporation failed to file its tax returns for the taxable years 1982 and 1983 within the time prescribed by law and that such failure was not due to reasonable cause. Accordingly, respondent determined the corporation was liable for a 25-percent addition to tax for these years pursuant to section 6651(a)(1).

In addition to the statute of limitations barring the assessment and collection of this addition to tax for the taxable year 1983, respondent stipulated that EAI timely filed its tax returns for both 1982 and 1983. See also sec. 6653(d). Accordingly, we do not sustain respondent's determination that the corporation is liable for this addition to tax for the taxable years 1982 or 1983.

D. Summary

For the taxable years 1980 and 1981, the corporation is liable for the addition to tax for fraud pursuant to section 6653(b). For the taxable year 1982, the corporation is liable for the addition to tax for fraud pursuant to section 6653(b)(1), the addition equal to 50 percent of the interest computed on the portion of the underpayment attributable to fraud pursuant to section 6653(b)(2), and the section 6661 addition for a substantial

understatement of income tax (if a substantial understatement exists). For the taxable year 1983, the corporation is not liable for any additions to tax.

VIII. ADDITIONS TO TAX--PETITIONER

A. Section 6653(b)/6653(b)(1)--Taxable Years 1980, 1981, 1982, and 1983

Section 6653(b)(2)--Taxable Years 1982 and 1983

Respondent determined that the underpayments of tax required to be shown on petitioner's returns for 1980, 1981, 1982, and 1983 were due to fraud. Accordingly, respondent determined petitioner was liable for the 50-percent addition to tax for fraud pursuant to section 6653(b) for the taxable years 1980 and 1981, and pursuant to section 6653(b)(1) for the taxable years 1982 and 1983. Respondent also determined petitioner was liable for the addition to tax for 1982 and 1983, pursuant to section 6653(b)(2), equal to 50 percent of the interest computed

on the portion of the underpayment attributable to fraud.

In the alternative to the addition to tax for fraud for 1982 and 1983, respondent determined petitioner was liable for the 5 percent addition to tax for negligence or intentional disregard of rules and regulations pursuant to section 6653(a)(1), and the addition equal to 50 percent of the interest computed on the portion of the underpayment attributable to negligence or intentional disregard of rules and regulations pursuant to section 6653(a)(2).

Again, for a taxpayer to be liable for the additions to tax for fraud, respondent must prove by clear and convincing evidence that (1) the taxpayer has underpaid his taxes for the year in issue, and (2) some part of the underpayment is due to fraud. Section. 6653(b) for 1980 and 1981; sec. 6653(b)(1) and 6653(b)(2) for 1982 and 1983; sec. 7454(a); Rule 142(b); DiLeo v.

Commissioner, 96 T.C. at 873. Respondent has established that petitioner underpaid his taxes for 1980 through 1983. Respondent has also established by clear and convincing evidence that the underpayment resulting from petitioner's failure to report the Gosen payments as income was due to fraud. Therefore, we sustain respondent's determination that petitioner is liable for the additions to tax for fraud pursuant to section 6653(b)/6653(b)(1) for the taxable years ended 1980, 1981, 1982, and 1983, and pursuant to section 6653(b)(2) for 1982 and 1983.

We note that Mrs. Alexander is not jointly and severally liable for petitioner's additions to tax for fraud pursuant to sections 6653(b)(1) or 6653(b)(2) for the taxable years 1982 and 1983. Sec. 6653(b)(4).

Because we sustain respondent's determination that petitioner is liable for the

addition to tax for fraud for the taxable years 1982 and 1983, petitioner cannot also be liable for the addition to tax for negligence in 1982 and 1983. Sec. 6653(b)(3).

B. Section 6661--Taxable Years 1982 and 1983

Respondent determined petitioner had a substantial understatement of income tax within the meaning of section 6661 for the taxable years 1982 and 1983. Accordingly, respondent determined petitioner was liable for an addition to tax for these years pursuant to section 6661. Petitioner contests the section 6661 addition to tax on several grounds. We have considered each of these grounds and find all but two to be either unpersuasive and without merit or not adequately proven by petitioner. We will not discuss any of these grounds but two.

Petitioner contests the section 6661 addition to tax on the ground that the

statute of limitations bars its collection and assessment. As discussed supra at section VI(B), the statute of limitations does not bar the assessment and collection of any additions to tax for which petitioner is determined liable.

Petitioner also contests the section 6661 addition to tax on the ground that there was no substantial understatement for 1982 and 1983. Regarding this contention, we have concluded that the Alexanders understated their income in these taxable years in the amounts determined by respondent; therefore, we sustain respondent's determination on this issue. See Benjamin v. Commissioner, 66 T.C. 1084, 1100--1101 (1976), affd. 592 F. 2d 1259 (5th Cir. 1979).

IX. ADDITIONS TO TAX--MRS. ALEXANDER

A. Section 6653(a)(1)--Taxable Years 1982 and 1983

Section 6653(a)(2)--Taxable Years 1982 and 1983

Respondent determined that the underpayments of tax required to be shown on Mrs. Alexander's returns for 1982 and 1983 were due to negligence or intentional disregard of rules and regulations. Accordingly, respondent determined that she was liable for the 5-percent addition to tax for negligence pursuant to section 6653(a)(1) for these years. Respondent also determined Mrs. Alexander was liable for the addition to tax equal to 50 percent of the interest computed on the portion of the understatement attributable to negligence or intentional disregard of rules and regulations for 1982 and 1983 pursuant to section 6653(a)(2).

Petitioner and Mrs. Alexander filed joint income tax returns for the taxable years 1982 and 1983. The liability for additions to tax for taxpayers who file

jointly is joint and several. Sec. 6013(d)(3); Pesch v. Commissioner, 78 T.C. 100, 129 (1982). We have found that petitioner is liable for the additions to tax for fraud pursuant to section 6653(b)(1) and (2) for the 1982 and 1983 taxable years. If we were to hold Mrs. Alexander liable in 1982 and 1983 for the additions to tax for negligence, petitioner would then be jointly and severally liable for the negligence additions to tax in these taxable years. A taxpayer cannot be liable for the addition to tax for fraud and the addition to tax for negligence. Sec. 6653(b)(3). Accordingly, we do not sustain respondent's determination on this issue as to Mrs. Alexander. See Minter v. Commissioner, T.C. Memo. 1991-448; Congelliere v. Commissioner, T.C. Memo 1990-265.

B. Section 6661--Taxable Years 1982 and 1983

Respondent determined that Mrs. Alexander had a substantial understatement of income tax within the meaning of section 6661 for the taxable years ended 1982 and 1983. Accordingly, respondent determined her liable for the addition to tax for these years pursuant to section 6661. Mrs. Alexander contests this addition on several grounds. We have considered each of these grounds and find all but two to be either unpersuasive and without merit or not adequately proven by Mrs. Alexander. We will not discuss any of these grounds but two.

Mrs. Alexander contests the section 6661 addition to tax on the ground that the statute of limitations bars its assessment and collection. As discussed supra at section VI(C), the statute of limitations does not bar the assessment and collection

of any additions to tax for which Mrs. Alexander is determined liable.

Mrs. Alexander contested the section 6661 addition on the ground that there was no substantial understatement for 1982 and 1983. Regarding this contention, we have concluded that the Alexanders understated their income in the taxable years 1982 and 1983 in the amounts determined by respondent; therefore, we sustain respondent's determination on this issue. See Benjamin v. Commissioner, supra at 1100--1101.

X. SHOKAI'S LIABILITY AS SUCCESSOR OF EAI

In 1984, Shokai and EAI merged into one corporation. Shokai became the surviving corporation and EAI the disappearing corporation. The tax liabilities in issue arose in the taxable years of EAI. Shokai asserts that it is liable for EAI's tax liabilities only as a "transferee" within the meaning of section 6901 and, therefore,

its tax liabilities are limited to those specified in that section. Respondent asserts that he does not have to resort to section 6901 to assess and collect EAI's deficiencies and additions to tax from Shokai because Shokai is primarily liable for EAI's tax liabilities.

Where a relevant State statute provides that a new corporation in a consolidated succeeds to, and is liable for, the debts and liabilities of the consolidated corporations to the same extent as though incurred by the new corporation, the new corporation is primarily liable for the tax obligations of the consolidated corporations. Saenger v. Commissioner, 38 B.T.A. 1295, 1300-1302 (1938); Oswego Falls Corp. v. Commissioner, 26 B.T.A. 60, 69-71 (1932), affd. 71 F. 2d 673 (2d Cir. 1934). This Court has indicated that this holding equally applies to corporations merged pursuant to State law. See Southern Pacific

Transportation Co. v. Commissioner, 84 T.C. 387, 394 (1985).

Therefore, where a relevant State statute provides that a surviving corporation in a merger succeeds to, and is liable for, the debts and liabilities of the disappearing corporation to the same extent as though incurred by the surviving corporation, the surviving corporation is primarily liable for the tax obligations of the disappearing corporation. Section 6901 also provides a procedure whereby the Commissioner may be able to assess and collect the tax liabilities of a taxpayer from a transferee to whom the taxpayer has distributed his assets. A surviving corporation in a merger can be both primarily liable for a transferor's debts and liable as a transferee. Southern Pacific Transportation Co. v. Commissioner, supra at 395.

Shokai and EAI merged pursuant to chapter 11 of the California Corporations Code. Section 1107 of chapter 11 provides that the surviving corporation in a merger pursuant to chapter 11 is subject to the debts and liabilities of the disappearing corporation in the same manner as if the surviving corporation had itself incurred them. Cal. Corp. Code sec. 1107 (West 1990). Therefore, Shokai is primarily liable pursuant to State law for the tax obligations of EAI. Accordingly, respondent need not resort to section 6901 to assess and collect EAI's deficiencies and additions to tax from Shokai.

To reflect the foregoing,

Decision will be entered for respondent in docket No. 16543-89.

Decisions will be entered under Rule 155 in docket Nos. 16443-89 and 18181-89.

UNITED STATES TAX COURT

Washington, D.C. 20217

ALEXANDER SHOKAI, INC., ET. AL.,	)	
Petitioners,	)	Docket Nos.
	)	16443-89
v.	)	16543-89
COMMISSIONER OF INTERNAL REVENUE,	)	18181-89
	)	Filed
Respondent.	)	1-23-92

O R D E R

This case was tried December 17 - 19, 1990 at a session of the Court commencing December 10, 1990, in Los Angeles, California. Prior to and during trial, petitioners and respondent objected to the admission into evidence of various exhibits and testimony.

On December 3, 1990, petitioners filed a two-part Motion in Limine with this Court. Pursuant to this Court's Order dated December 17, 1990, one part of this Motion was denied and one part was taken under advisement. In the part taken under advise-

ment, petitioners specifically objected to the admission of three letters written by the Japanese National Tax Administration to the IRS dated May 7, 1984, March 14, 1986, and August 14, 1986. Petitioners objected to the admission of these letters on the grounds of hearsay. Because the letters dated March 14, 1986 and August 14, 1986, proved unnecessary for a proper resolution of these cases, we need not rule on their admissibility. The Court marked the letter dated May 7, 1984, for identification as Exhibit "S". Petitioners objected to the admission of Exhibit S on the grounds of (1) lack of relevancy and (2) hearsay. First, because this document proved necessary to properly resolve these cases, the document was relevant. Accordingly, petitioner's objection of this ground is overruled. Second, Rule 802 of the Federal Rules of Evidence generally precludes the admission of hearsay into evidence. However, a well-

established exception to the hearsay rule is that evidence is admissible if it is not admitted into evidence for testimonial use but rather is admitted to show the information on which a party acted. Emich Motors Corp. v. General Motors Corp., 181 F. 2d 70, 82 (7th Cir. 1950), revd. on other grounds 340 U.S. 558 (1950). In the instant case, this letter was not offered to prove the truth of any facts stated in the letter, i.e., it was not offered for testimonial use. It was admitted to prove the Japanese National Tax Administration notified the IRS of the potential existence of petitioner's foreign account, the agreements with Gosen Co., Ltd., and the commission payments received by petitioners. Thus, it was admitted only to show the information on which the IRS acted. Therefore, the letter is not hearsay for purposes of the reason it was offered. Accordingly, petitioner's objection on this ground is overruled.

At trial, petitioners offered into evidence the testimony taken by deposition of Mr. Yutaka Takashima, president of Gosen Co. Ltd. of Osaka, Japan. While respondent had requested this deposition, he stated his intention not to introduce this deposition into evidence because the witness was unresponsive to the questions asked of him. This Court marked the deposition for identification as Exhibit Number "79", and took its admissibility under advisement. Mr. Takashima's testimony by deposition proved unnecessary for proper resolution of these cases. Accordingly, we need not rule on its admissibility.

Further, at trial, the parties filed their Stipulation of Facts with this Court. In their Stipulation, both parties objected to the admission of particular exhibits into evidence on many varied grounds of contention. Other than the exhibits listed below, the exhibits the parties objected to

proved unnecessary to properly resolve these cases; accordingly, we need not rule on the admissibility of these exhibits. The following exhibits, however, proved necessary to properly resolve these cases and were admitted into evidence for the reasons stated below:

(1) Exhibits "6-F," "50-AX," and "51-AY" - Notices of Deficiency issued to Alexander Shokai, Inc., as successor of E. Alexander, Inc., Edward Alexander, and Estelle Alexander. Petitioners objected to the admission of these documents on various grounds but did not object if the documents were used solely to prove they were sent or to prove the proposed deficiencies were as stated. These documents were used only as proof that they were sent and that the proposed deficiencies were as stated. Accordingly, we need not rule on

petitioners' other objections.

(2) Exhibit "S" - Letter dated May 7, 1984, from the Japanese National Tax Administration to Foreign Operations District of the Internal Revenue Service. This letter is the same as referred to in respondent's Motion in Limine filed with the Court of December 3, 1990. This letter was admitted into evidence for the reasons stated supra.

Further, at trial, petitioners offered into evidence the testimony of Mr. Michael Christianson, an attorney, to testify as a qualified expert in the fields of international tax law and the business customs of Japanese businessmen. Petitioners also offered into evidence a report written by Mr. Christianson as an expert. Respondent objected to the admission of Mr. Christianson's testimony and written

report on the ground that he was not qualified as an expert in either of these fields. This Court took respondent's objections under advisement. The testimony and report of Mr. Christianson proved unnecessary for proper resolution of these cases. Accordingly, respondent's oral motion is moot.

Upon due consideration of the premises stated and for cause, it is

ORDERED that the second part of petitioners' Motion in Limine to exclude Exhibit "S" from evidence is denied.

The parties are hereby advised that the remaining informal objections to the admission of evidence that are referred to herein are disposed of as provided in this Order.

(Signed) Lawrence A. Wright

Judge

Dated: Washington, D.C.
January 23, 1992

UNITED STATES TAX COURT

ALEXANDER SHOKAI, INC., Petitioner,	)	
v.	)	Docket No. 16443-89
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	Filed 7-13-92

DECISION

Pursuant to the opinion of the Court filed January 21, 1992, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there are deficiencies in income tax and additions to tax due from the petitioner as follows:

Tax Year Ending	Income Tax Deficiency	Additions to Tax Code Sections 6653(b)(1)	6653(b)(2)	6661
2/28/81	$129,033.84	$64,516.92	n/a	n/a
2/28/82	$101,425.94	$50,712.97	n/a	n/a
2/28/83	$133,214.55	$66,607.28	*	$33,304.00
2/28/84	-0-	-0-	-0-	-0-

*50 percent of the interest due on $113,752.00

That there are no additions to tax due from the petitioner pursuant to I.R.C. § 6653(a)(1) or 6653(a)(2) or 6651(a), for the taxable years ending February 28, 1983 and 1984.

(Signed) Lawrence A. Wright

Judge

Entered: July 13, 1992

* * * * * * * *

The parties stipulate that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

ABRAHAM N.M. SHASHY, JR.
Chief Counsel
Internal Revenue Service
By: /s/ Louis B. Jack
/s/ Michael K. Phalin
LOUIS B. JACK (JL0001)
Attorney for Respondent
IRS District Counsel
P.O. Box 30215
Laguna Niguel, CA 92607
(714) 643-4325
Date: June 23, 1992

/s/ Ronald K. Van Wert
RONALD K. VAN WERT (VR0111)
Attorney for Petitioner
One Newport Place - Ste. 900
1301 Dove Street
Newport Beach, CA 92660
(714) 752-7964

Date: 6/16/92

UNITED STATES TAX COURT

EDWARD ALEXANDER, Petitioner, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	Docket No. 16543-89 Filed July 13, 1992

DECISION

Pursuant to the opinion of the Court filed January 21, 1992, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there are deficiencies in income tax and additions to tax due from the petitioner as follows:

Tax Year	Income Tax Deficiency	Additions to Tax Code Sections		
		6653(b)(1)	6653(b)(2)	6661
1980	$133,564.00	$66,782.00	n/a	n/a
1981	$159,630.00	$79,815.00	n/a	n/a
1982	$127,993.00	$63,996.00	*	$31,998.00
1983	$132,081.00	$66,040.00	*	$33,020.00

*50 percent of the interest due on $127,993.00 and $132,081.00

There are no additions to tax due from the petitioner pursuant to I.R.C. § 6653(a)(1) or 6653(a)(2) for the taxable years 1982 or 1983.

(Signed) Lawrence A. Wright
Judge

Entered: July 13, 1992

* * * * * * *

The parties stipulate that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

ABRAHAM N.M. SHASHY, JR.
Chief Counsel
Internal Revenue Service

By: /s/ Louis B. Jack
LOUIS B. JACK (JL0001)
Attorney for Respondent
IRS District Counsel
P.O. Box 30215
Laguna Niguel, CA 92607
(714) 643-4325
Date: May 19, 1992

/s/ Ronald K. Van Wert
RONALD K. VAN WERT (VR0111)
Attorney for Petitioner
One Newport Place - Ste. 900
1301 Dove Street
Newport Beach, CA 92660
(714) 752-7964

Date: May 8, 1992

UNITED STATES TAX COURT

ESTELLE ALEXANDER, Petitioner, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	Docket No. 18181-89 Filed July 13, 1992

DECISION

Pursuant to the opinion of the Court filed January 21, 1992, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there are deficiencies in income tax due from the petitioner for the taxable years 1982 and 1983 in the amounts of $127,993.00 and $132,081.00, respectively;

That there are no additions to tax due from the petitioner pursuant to I.R.C. §

6653(a)(1) or 6653(a)(2), for the taxable years 1982 and 1983; and

That there are additions to tax due from the petitioner pursuant to I.R.C. § 6661 for the taxable years 1982 and 1983, in the amounts of $31,998.00 and $33,020.00, respectively.

(Signed) Lawrence W. Wright
Judge

Entered: July 13, 1992

* * * * * * *

The parties stipulate that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

ABRAHAM N.M. SHASHY, JR.
Chief Counsel
Internal Revenue Service

By: /s/ Louis B. Jack
LOUIS B. JACK (JL0001)
Attorney for Respondent
IRS District Counsel
P.O. Box 30215
Laguna Niguel, CA 92607
(714) 643-4325
Date: May 19, 1992

/s/ Ronald K. Van Wert
RONALD K. VAN WERT (VR0111)
Attorney for Petitioner
One Newport Place - Ste. 900
1301 Dove Street
Newport Beach, CA 92660
(714) 752-7964

Date: May 8, 1992

(2)

Supreme Court, U.S.
FILED
MAR 15 1995
OFFICE OF THE CLERK

No. 94-1204

In the Supreme Court of the United States

OCTOBER TERM, 1994

ALEXANDER SHOKAI, INC., ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

DREW S. DAYS, III
Solicitor General

LORETTA C. ARGRETT
Assistant Attorney General

GILBERT S. ROTHENBERG
SARA S. HOLDERNESS
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 514-2217

BEST AVAILABLE COPY

17pp

QUESTIONS PRESENTED

1. Whether the court of appeals correctly determined that *ex parte* communications between government counsel and the Tax Court did not unfairly prejudice petitioners.

2. Whether the Tax Court abused its discretion in failing to rule on the admissibility of various exhibits after it determined that they were unnecessary for resolution of the case.

3. Whether payments received by petitioner Edward Alexander were taxable at the time of receipt under the claim-of-right doctrine.

4. Whether the imposition of additions to tax for fraud under Section 6653(b) of the Internal Revenue Code violates the Due Process Clause of the Fifth Amendment or the Excessive Fines Clause of the Eighth Amendment.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	2
Argument	7
Conclusion	13

TABLE OF AUTHORITIES

Cases:

Barnette v. *Commissioner*, 95 T.C. 341 (1990)	13
Browning-Ferris Industries of Vermont, Inc. v. *Kelco Disposal, Inc.*, 492 U.S. 257 (1989)	12
Commissioner v. *Indianapolis Power & Light Co.*, 493 U.S. 203 (1990)	6, 10, 11, 12
Guenther v. *Commissioner*, 889 F.2d 882 (9th Cir. 1989)	8
Healy v. *Commissioner*, 345 U.S. 278 (1953)	10, 11
Helvering v. *Mitchell*, 303 U.S. 391 (1938)	13
Ianniello v. *Commissioner*, 98 T.C. 165 (1992)	13
James v. *United States*, 366 U.S. 213 (1961)	12
Mullane v. *Central Hanover Bank & Trust Co.*, 339 U.S. 306 (1950)	8
North American Oil Consolidated v. *Burnet*, 286 U.S. 417 (1932)	10, 12
Rose v. *Clark*, 478 U.S. 570 (1986)	8
United States v. *Claiborne*, 765 F.2d 784 (9th Cir. 1985), cert. denied, 475 U.S. 1120 (1986)	9
United States v. *Cronic*, 466 U.S. 648 (1984)	8
United States v. *Halper*, 490 U.S. 435 (1989)	13
United States v. *Minsky*, 963 F.2d 870 (6th Cir. 1992)	8
Ware v. *Commissioner*, 906 F.2d 62 (2d Cir. 1990)	12
Wisniewski v. *United States*, 353 U.S. 901 (1957)	8
Zobrest v. *Catalina Foothills School Dist.*, 113 S. Ct. 2462 (1993)	12

Constitution and statutes: Page

U.S. Const.:
Amend. V (Due Process Clause) 12
Amend. VIII (Excessive Fines Clause) 12, 13
Internal Revenue Code (26 U.S.C.):
§ 301(c)(1)-(3) 4
§ 316(a) 4
§ 1341 10
§ 6653(b) (1982) 12, 13
§ 6653(b)(1) (1982) 12, 13
§ 6653(b)(2) (1982) 13

In the Supreme Court of the United States

OCTOBER TERM, 1994

No. 94-1204

ALEXANDER SHOKAI, INC., ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 40-81) is reported at 34 F.3d 1480. The memorandum opinion of the Tax Court (Pet. App. 83-191) is reported at 63 T.C.M. (CCH) 1870.

JURISDICTION

The judgment of the court of appeals was entered on September 2, 1994. A petition for rehearing was denied on October 13, 1994. Pet. App. 82. The petition for a writ of certiorari was filed on January 10, 1995. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. From 1980 through 1983, petitioner Edward Alexander was the president and sole stockholder of E. Alexander Inc. (EAI), the corporate predecessor of petitioner Alexander Shokai, Inc. (ASI). EAI became the U.S. sales agent for tennis racquet strings produced by Gosen Co., Ltd., a Japanese corporation. In 1979, Gosen agreed to pay EAI a 10% commission on all sales Gosen made to EAI or to EAI's foreign customers. Gosen also agreed to make refunds to EAI if the exchange rate between yen and dollars fluctuated by a certain amount from the time Gosen billed EAI to the time EAI made payment. Gosen and Alexander further agreed orally that if the Japanese National Tax Administration (JNTA) disallowed deductions for any of the payments required by Gosen's commission and exchange rate agreements with EAI, Alexander would personally repay Gosen. Pet. App. 50-51.

Alexander instructed Gosen to deposit the commission and exchange rate payments into a personal bank account that he maintained in Japan. From 1980 through early 1984, Gosen deposited approximately $944,000 in Alexander's account. From 1980 through 1983, Alexander withdrew more than $565,000 from the account, both to pay for traveling expenses in Japan and to deposit into his personal bank accounts in the United States. None of the Gosen payments was deposited into EAI's corporate bank account or recorded on EAI's books. Pet. App. 52, 53.

Alexander described the Gosen payments to his friend Kenneth Bartelt, a retired accountant. According to Alexander, Bartelt advised him that the Gosen payments would not be taxable in the United States unless the money was returned to this country. Bartelt's son,

Edward Bartelt, prepared federal income tax returns both for EAI and for Alexander and his wife (petitioner Estelle Alexander) for each of the 1980-1983 tax years. Alexander did not inform Edward Bartelt of EAI's agreements with Gosen or of Gosen's payments, and none of the payments was reported on any of the returns filed in those years by EAI and the Alexanders. Pet. App. 52-53.

The JNTA completed an audit of Gosen in 1984. It allowed Gosen's deductions of the payments made to Alexander, but it also informed the Internal Revenue Service of the existence of the Gosen agreements, the Gosen payments, and Alexander's individual bank account in Japan. After the IRS began to investigate, Alexander consulted Edward Bartelt and other financial advisors about the Gosen transactions. They concluded that the Gosen payments had not accrued as income until the JNTA had finished its audit in 1984, because until that time Alexander had a contingent obligation to repay Gosen if the JNTA disallowed the deductions. The Gosen payments were first included on the 1984 returns filed by the Alexanders and by petitioner ASI, also wholly owned by Mr. Alexander, which succeeded to all of EAI's rights and obligations through a merger concluded in that year. Pet. App. 53-54.

In 1989, the IRS issued notices of deficiency to ASI and to each of the Alexanders. The ASI notice alleged that EAI had received approximately $944,000 in unreported income from Gosen between 1980 and 1983. The IRS also sought additions to tax based on fraud for the years 1980-1983, and based on substantial understatement of income for the years 1982-1983. The notice to Edward Alexander alleged that the Gosen payments were gross receipts of EAI that Alexander had diverted for his own use, and were therefore taxable as unreported

dividend income of about $897,000 for the years 1980-1983 and a net capital gain of about $15,000 in 1983.[1] The IRS also sought additions to tax for fraud for the years 1980-1983, and for substantial understatement of income for the years 1982-1983. The notice issued to Estelle Alexander alleged that she was liable for the same tax deficiencies as her husband and for the substantial understatement penalties for 1982-1983, but sought no penalty for fraud. Pet. App. 54-55, 115-119.

2. Petitioners filed separate petitions in the Tax Court seeking redetermination of the deficiencies and additions to tax. The court consolidated the cases for trial. Pet. App. 83 & n.1. In December, 1990, the court held a pretrial hearing on a motion by Edward Bartelt to quash a subpoena served on him by the government. *Id.* at 56-57; Pet. 12. Petitioners' counsel knew of the hearing, but was excused from attending because Bartelt's motion was the only item scheduled to be heard. Pet. App. 57.

After the court ruled on the motion to quash, government counsel submitted to the court a motion in limine, an opposition to petitioners' motion in limine, and a motion to compel production of documents, all of which were served on petitioners' counsel that same day. The court expressly reserved any ruling until petitioners' counsel could be heard. The court inquired, however, about the government's motion. In response, counsel stated the government's positions that the report of

---

[1] The notice treated the diverted funds as dividends to the extent of EAI's earnings and profits (as computed for federal income tax purposes), and as capital gains to the extent they exceeded both available earnings and profits and Alexander's adjusted basis in the corporation's stock. See generally 26 U.S.C. 301(c)(1)-(3) and 316(a).

petitioners' expert witness was hearsay and that the testimony of petitioners' accounting expert was irrelevant. The court also inquired about the status of the government's deposition of Gosen's president, to which counsel responded that he felt he was being "stonewalled" by Gosen. Finally, counsel stated that he was having serious problems reaching factual stipulations with petitioners' counsel. Pet. App. 57-59; Gov't C.A. Br. 12-13.

After trial, the Tax Court agreed with the government that the Gosen payments constituted gross receipts of EAI that had been diverted by Mr. Alexander for personal use, and that these payments should have been reported as income by EAI and by the Alexanders in the years Mr. Alexander received them. The court rejected petitioners' argument that the payments were not income in the year of receipt because of the chance that they would have to be returned if the JNTA disallowed Gosen's deductions. The court held that the payments were reportable upon receipt because Alexander received them under a "claim of right" and exercised sufficient control over their disposition. Pet. App. 139-142.

The court also found that the government had proved by clear and convincing evidence that Alexander had fraudulently under-reported his taxable income for the years 1980-1983. The court pointed to various indications of fraud, including Alexander's consistent and substantial understatements of income, his failure to keep records of the amounts earned and received from Gosen, his attempt to conceal the existence of the Gosen payments, and his inconsistent explanations of why he did not report the Gosen payments in the years he received them. Pet. App. 148-155. The court also held that Alexander's fraudulent intent could be imputed to EAI for the years 1980-1982, during which he was its sole

stockholder and dominant officer. With respect to 1983, however, the court held that the corporation was not liable for fraud or negligence because it reasonably relied on the advice of professional tax advisers in preparing its returns for that year. *Id.* at 162-168. Finally, the court sustained the additions for substantial understatement of income imposed on the Alexanders for 1982-1983 and on EAI for 1982. *Id.* at 178, 184, 188.

In a separate post-trial order the court ruled that, with exceptions not relevant here, the exhibits to which the parties had refused to stipulate were not necessary to the proper resolution of the case. The court therefore declined to rule on their admissibility. Pet. App. 195-196. The court also denied petitioners' motion for a new trial based on the allegedly improper *ex parte* communications between the court and the government's counsel at the hearing on the motion to quash. See *id.* at 56.

3. The court of appeals affirmed. Pet. App. 40-81. The court held that the court's colloquy with government counsel concerning matters not mentioned in the notice of the hearing on the motion to quash was an improper *ex parte* communication. The court concluded, however, that petitioners received notice of the motions filed at the time and an adequate opportunity to respond, and that nothing in the transcript indicated that any *ex parte* statement affected the fairness of the trial. The court therefore held that petitioners suffered no prejudice from the *ex parte* colloquy, and upheld the Tax Court's refusal to order a new trial. *Id.* at 59-60.

The court also upheld the Tax Court's application of the "claim of right" doctrine in determining that the Gosen payments were includible in income in the year of receipt. The court rejected petitioners' reliance on this Court's decision in *Commissioner* v. *Indianapolis Power & Light Co.*, 493 U.S. 203 (1990), noting that the

utility company taxpayer in that case had "an absolute obligation to repay the deposits [at issue] to their customers if a request for repayment was made." Pet. App. 63-64.

The court affirmed the fraud penalties imposed against Mr. Alexander and his corporation. The court rejected petitioners' argument that Alexander reasonably relied on Kenneth Bartelt's advice that the Gosen payments were not taxable until brought into the United States and on Edward Bartelt's expertise in preparing his federal tax returns. The court noted that Alexander "failed to report the Gosen payments as income even after he had partially transferred them to accounts in the United States," and that he "failed to disclose the Gosen payments, the Gosen agreements or the oral contingent agreement" to Edward Bartelt. Pet. App. 68-69. The court also rejected petitioners' arguments that fraud could not be found where the proper treatment of the Gosen payments was unclear, that the Tax Court had applied an objective rather than a subjective standard in assessing Alexander's claimed belief that no taxes were due, and that the Tax Court had improperly disregarded evidence tending to disprove fraud. *Id.* at 65-67, 71-72.

ARGUMENT

1. Petitioners contend (Pet. 22-25) that they were entitled to a new trial because the Tax Court judge asked government counsel, at a pretrial hearing on other issues from which petitioners' counsel had requested to be excused, a series of brief questions about the government's positions on pending motions and counsel's perception of the progress of the discovery and stipulation process. The court of appeals agreed with petitioners that the judge's questions and government counsel's answers amounted to improper *ex parte* com-

munications. Pet. App. 58. Having concluded that those communications did not prejudice petitioners or affect the outcome of the trial, however, the court upheld the Tax Court's refusal to order a new trial. *Id.* at 58-60.

As the court of appeals recognized (Pet. App. 56), an *ex parte* communication, like most other procedural flaws, amounts to reversible error only if it results in some prejudice to the absent party. Petitioners cite (Pet. 22-23) criminal cases involving denial of the right to counsel, see *United States* v. *Cronic*, 466 U.S. 648 (1984), and application of the standard for finding harmless constitutional error in criminal proceedings, see *Rose* v. *Clark*, 478 U.S. 570 (1986) (reversing decision requiring per se reversal); *United States* v. *Minsky*, 963 F.2d 870 (6th Cir. 1992) (finding *ex parte* sidebar at trial not harmless). Those decisions are inapposite here.[2] The essence of procedural due process is notice and the opportunity to be heard. *E.g.*, *Mullane* v. *Central Hanover Bank & Trust Co.*, 339 U.S. 306, 313-314 (1950). In this case, as the court of appeals observed (Pet. App. 59-60), petitioners were served with every document filed in their absence, the trial judge explicitly stated that he would make no rulings until their counsel could be heard, and petitioners ultimately had a full opportunity to respond. After reviewing the trial transcript, the court

---

[2] Petitioners suggest (Pet. 25) that the decision below conflicts with the same court's earlier decision in *Guenther* v. *Commissioner*, 889 F.2d 882 (1989). To the contrary, the court in this case followed *Guenther* (Pet. App. 56), which held (889 F.2d at 884) that the existence of reversible error depends on whether the absent party was "unfairly prejudiced" by not being afforded "an opportunity to participate in determination of the relevant issues." In any event, any inconsistency with *Guenther* would be a matter for resolution by the court of appeals. See *Wisniewski* v. *United States*, 353 U.S. 901, 902 (1957).

was "convince[d] * * * that the *ex parte* communications did not taint the trial." *Ibid.* Under the circumstances, petitioners plainly were not entitled to a new trial.

2. Petitioners contend (Pet. 25-33) that the Tax Court abused its discretion by failing to rule on the admissibility of certain personal financial statements prepared by Edward Bartelt. Petitioners offered those statements in an attempt to show that Mr. Alexander disclosed to Bartelt the increases in his U.S. assets that resulted when he deposited portions of the Gosen payments in his U.S. bank accounts. Petitioners argue that such disclosure establishes that Alexander could not be liable for fraud because he was attempting to comply in good faith with what he conceived to be his legal responsibility (to report the Gosen payments as income if and when they were repatriated), and because the actual failure to report *any* of the payments as income was not his fault but that of Bartelt, who prepared his returns. Pet. App. 27, 30.

As the court of appeals explained (Pet. App. 68), Alexander's claim that he relied on a belief that he need only report repatriated payments is refuted by the fact that he failed to report any of the Gosen payments, including those transferred to his U.S. accounts, until 1984, after the commencement of an IRS investigation. And Alexander cannot shift the responsibility for that failure to the accountant who prepared his returns when, as the court observed (*ibid.*), the two never discussed the payments and Alexander did not disclose to the accountant the existence of either the payments themselves or the agreements under which they were made. See, *e.g.*, *United States* v. *Claiborne*, 765 F.2d 784, 798 (9th Cir. 1985), cert. denied, 475 U.S. 1120 (1986). The Tax Court carefully reviewed the evidence in this case

(see Pet. App. 146-157) and concluded (*id.* at 157) that the government had proved "by clear and convincing evidence that [Alexander] intended to evade paying taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of taxes due." Both courts below concluded that additional evidence that Alexander had provided his accountant with financial data from which accessions to wealth could have been inferred, without discussing with him the source, nature, or proper tax treatment of those accessions, would not have changed the trial court's ultimate finding. See *id.* at 74, 195-196. That fact-bound conclusion does not warrant further review.

3. Relying on *Commissioner* v. *Indianapolis Power & Light Co.*, 493 U.S. 203 (1990), petitioners argue (Pet. 33-35) that because the Gosen payments were subject to a contingent repayment obligation until the completion of the JNTA's audit of Gosen in 1984, petitioners were not required to include those payments in income until that year. The court of appeals correctly rejected that argument.

As the court of appeals held (Pet. App. 64), the Gosen payments were income when received under the claim-of-right doctrine. Amounts received under a claim of right, without restriction as to their use or disposition, are includible when received, even if they are subject to actual or potential claims challenging the taxpayer's right to retain them. *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 424 (1932); see *Healy* v. *Commissioner*, 345 U.S. 278, 281-282 (1953).[3] A taxpayer

---

[3] If the taxpayer is later required to repay all or part of the money, an offsetting deduction or credit is allowed in the year of repayment. *North American Oil*, 286 U.S. at 424; see also 26 U.S.C. 1341.

holds funds under a claim of right when those funds are "received and treated by [the] taxpayer as belonging to him." *Healy*, 345 U.S. at 282. In this case, Alexander "freely withdrew money from the account [into which the Gosen payments were deposited] and treated it as his own." Pet. App. 64. The court of appeals therefore correctly held (*ibid.*) that Alexander received the payments under a claim of right, and that they were includible in income when received.

The court of appeals properly distinguished this Court's decision in *Indianapolis Power*. That case addressed the question whether utility companies that required customers to make deposits to ensure the collection of future electric bills were required to report the amounts deposited as income. The Court rejected the government's argument that the amounts received were best characterized as immediately taxable advance payments for electricity, holding instead that they were more similar to loans, and were not reportable as income until drawn down to cover a particular delinquent bill. The Court reasoned that "[t]he customer who submits a deposit to the utility, like [a] lender * * *, retains the right to insist upon repayment in cash," and "the utility therefore acquires no unfettered 'dominion' over the money at the time of receipt." 493 U.S. at 212. In this case, by contrast, the Gosen payments "bore no resemblance to loans or deposits," because "Gosen could demand repayment of [the] Gosen payments from [petitioners] *only if* the JNTA * * * disallowed the deductions." Pet. App. 64.

Petitioners focus (Pet. 33) on this Court's statement in *Indianapolis Power* that "[t]he key is whether the taxpayer has some guarantee that he will be allowed to keep the money." 493 U.S. at 210. As the court of appeals pointed out (Pet. App. 62), that statement was

made in the context of distinguishing deposits from advance payments for goods and services; it has no application in determining whether a payment for past services, which the taxpayer intends and expects to retain, is subject to such a risk of divestment that it cannot properly be viewed as current income. Under petitioners' reading, *Indianapolis Power* would effectively overrule the claim-of-right cases. Nothing in this Court's opinion suggests that result. See *Indianapolis Power*, 493 U.S. at 209 (quoting *James* v. *United States*, 366 U.S. 213, 219 (1961), and *North American Oil Consolidated* v. *Burnet*, *supra*).[4]

4. Finally, petitioners contend (Pet. 35-38) that the imposition of additions to tax for fraud under Section 6653(b) of the Internal Revenue Code violates the Due Process Clause of the Fifth Amendment and the Excessive Fines Clause of the Eighth Amendment. Petitioners did not raise those constitutional arguments before either the Tax Court or the court of appeals, and they may not properly be raised for the first time in this Court. See, *e.g.*, *Zobrest* v. *Catalina Foothills School Dist.*, 113 S. Ct. 2462, 2466 (1993); *Browning-Ferris Industries of Vermont, Inc.* v. *Kelco Disposal, Inc.*, 492 U.S. 257, 277 (1989).

In any event, petitioners' contentions are meritless. For the years in issue (1980-1983), Section 6653(b)(1) imposed an addition to tax of 50% of the entire underpayment if any part of the underpayment was due to

---

[4] Petitioners suggest (Pet. 20, 33-34) a conflict between the decision below and *Ware* v. *Commissioner*, 906 F.2d 62, 65 (2d Cir. 1990). *Ware* cited *Indianapolis Power* in holding that a partnership did not realize certain fee income for tax purposes when it was paid into escrow pending resolution of a dispute over the fee. That situation is remote from the facts of this case.

fraud, and Section 6653(b)(2) imposed an addition of 50% of the interest due on the part of any underpayment that was attributable to fraud. 26 U.S.C. 6653(b)(1) and (2) (1982). Petitioners argue that the additions in this case are excessive under the Eighth Amendment because they "bear no relationship to the harm" caused to the government (Pet. 37), and that they violate due process because "there is no mechanism for review of the amount once fraud is found" (Pet. 38). But the additions imposed by Section 6653(b) are neither arbitrary nor excessive. As this Court has recognized, the civil fraud penalty is reasonably calculated to compensate the government for the costs incurred in detecting, investigating, and prosecuting petitioners' fraud. See *Helvering* v. *Mitchell*, 303 U.S. 391, 401 (1938); see also *Ianniello* v. *Commissioner*, 98 T.C. 165, 187 (1992); *Barnette* v. *Commissioner*, 95 T.C. 341, 348 (1990); cf. *United States* v. *Halper*, 490 U.S. 435, 441-446, 449-450 (1989) (distinguishing *Mitchell*).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

DREW S. DAYS, III
Solicitor General

LORETTA C. ARGRETT
Assistant Attorney General

GILBERT S. ROTHENBERG
SARA S. HOLDERNESS
Attorneys

MARCH 1995